Supreme Court, U.S.
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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1995

NO. _____

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PATRICK J. KEOGH and JUDITH KEOGH,

Petitioners,

versus

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

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# PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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## OPINIONS BELOW

The United States Tax Court rendered two opinions below. The first, in connection with the petitioner-taxpayers' motion for summary judgment was reported at Dec. 46,455M; 59 TCM 89; TC Memo 1990-131. The second opinion is reported at Dec.48,049M; 63 TCM 2283; TC Memo 1992-131. The United States Court of Appeals for the Second Circuit rendered its opinion on March 30, 1995, which is reported at 52 F.3rd 312. A petition for rehearing was timely filed and denied by the Second Circuit on July 20, 1995.

## BASIS OF JURISDICTION

The jurisdiction of this Court is invoked under Title 28 U.S.C. Sec. 1254(1), to review the decision of the United States Court of Appeals for the Second Circuit affirming the opinion and decision of the United States Tax Court.

## STATUTES AND RULES INVOLVED

The applicable sections of the Internal Revenue Code of 1954 and 1986, as amended, the Tax Court Rules of Practice and Procedure, the Federal Rules of Civil Procedure, Federal Rules of Evidence, and Rules of the United States District Court for the District of Columbia, are set forth in Appendix A, infra.

## STATEMENT OF FACTS

A petition was filed by the petitioners (hereinafter sometimes referred to as the "taxpayers"), Patrick J. Keogh and Judith Keogh, in the United States Tax Court (hereinafter sometimes referred to as the "Tax Court"), for a redetermination of a proposed deficiency in income taxes, penalties and interest set forth by the Commissioner of Internal Revenue (hereinafter sometimes referred to as the "respondent"), in a notice of deficiency dated March 21, 1989 for the taxable years 1985 and 1986. The case was tried on March 23, 1990 in Hartford, Connecticut before the Hon. Meade Whittaker. On March 4, 1992 the Tax Court rendered its Opinion and its Decision was entered on May 5, 1992. Thereafter, an appeal was taken to the United States Court of Appeals for the Second Circuit, which affirmed the Tax Court decision on March 30, 1995. A petition for rehearing was timely filed with the Second Circuit and denied on July 20, 1995.

The taxpayers are husband and wife and reside at 56 Deerfield Drive in the Town of Easton, Fairfield County, Connecticut. They timely filed their joint federal income tax returns for the calendar years 1985 and 1986 with the Internal Revenue Service Center, Andover, Massachusetts, showing a gross income of $1,159,398.60 and

federal income tax due and owing in the amount of $509,367.00 for 1985, and a gross taxable income of $111,545.00 and a federal income tax due and owing in the amount of $37,067.00 for 1986. (Stip. Par. 2, Exs. 1-A and 2-B)

The taxpayer, Keogh, had reported the sale of certain shares of stock of Computronics Distributing, Inc. on Schedule D of his 1985 joint federal income tax return as a long term capital gain on the grounds that the stock had been received pursuant to an incentive stock option, and that he was legally entitled to capital gains treatment under Section 422A of the Internal Revenue Code of 1954, as amended.

On March 21, 1989 the respondent mailed the taxpayers by certified mail a Notice of Deficiency, stating there was a deficiency in income taxes, penalties, and interest for 1985 and 1986, as follows:

| Taxable Period | Deficiency | Penalty Sec.[1] 6653(a)(1)(A) | Penalty[2] Sec. 6661 | Penalty[1] 6653(a)(1)(B) |
|---|---|---|---|---|
| 1985 | $ 748,899 | $ 37,295 | $ 186,475 | 50% of the interest due on $748,899 |
| 1986 | $ 9,392 | $ 470 | $ 2,348 | 50% of the interest due on $ 9,392. |

In the notice of deficiency, the respondent took the position the taxpayer did not meet the capital gain requirements of Section 422A of the Code and that the amount received by the taxpayer on the sale of his Computronics stock should have been taxed as ordinary income under Section 83 of the Code.

By way of background, on May 1, 1982 a Distributorship Agreement was entered into between Epson America, Inc., a California corporation (hereinafter referred to as "Epson") and Vitex Distributors, Inc., a Delaware corporation, which subsequent to May 1, 1982 changed its name to Computronics Distributing, Inc. (Stip. Pars. 4, 8 and 14, Ex. 5-E) Computronics was formed as a subsidiary of Epson America, Inc. to serve as a distributor of all Epson brand printers, microprocessors, and microprocessor-related products. (Stip. Par. 4)

Also on May 1, 1982 the taxpayer, Patrick J. Keogh, entered into an Employment Agreement with Vitex (Computronics) to serve as Computronics' president and chief executive officer, and also entered into an (stock) Option Agreement with Epson and Vitex (Computronics). (Stip. Par. 5, Ex. 4-D) This Option Agreement was

later amended pursuant to the Amendment to Option Agreement entered into as of April 30, 1985 by and among Epson, Computronics and taxpayer. (Stip. Par 15, 18-R) On May 1, 1985, three years later, a Repurchase Agreement was entered into by and among Epson, Computronics and the taxpayer whereby the stock was to be repurchased from the taxpayer by Epson. (Stip. Par. 38, Ex. 42-AP)

Computronics was one of twelve subsidiaries formed on or about April 22, 1982 by Epson to act as regional distribution centers for Epson products throughout the United States. (Stip. Par 6) The twelve distributorships were to act as exclusive distributors of all Epson label products. (Stip. Par. 7)

The sales and marketing territory for Computronics consisted of all five boroughs of New York City, Nassau, Suffolk, Rockland, and Westchester counties in New York State, and Fairfield County in Connecticut, and New Jersey south to the northern boundaries of Ocean and Burlington counties. (Stip. par. 9)

The authorized capital stock of Computronics was 200,000 shares of common stock. (Stip. Par. 11) Epson made a capital contribution of $375,000.00 in exchange for 37,500 shares of Computronics (or $10.00 per share) at the time of incorporation. The taxpayer paid $25,000.00 cash in exchange for his option rights. (Stip. Par. 12)

Epson also entered into Distributorship Agreements with eleven other subsidiaries to serve the regional areas of the rest of the country. (Stip. Par. 10 Exs. 6-F through 6-P) Each of the other 11 subsidiaries had authorized capital stock in the amount of 200,000 shares, and for each of the other 11 subsidiaries Epson made a capital contribution of $375,000.00 in exchange for 37,500 shares. (Stip. Par. 13) Epson also entered into similar Option Agreements with each of its other 11 distributorship subsidiaries and those subsidiaries' presidents on May 1, 1982, giving each president the right to purchase the shares of his distributorship stock for five ($5.00) dollars per share.

By the terms of Paragraphs 1.1.1. through 1.1.3. of taxpayer's Option Agreement, Keogh had the option, at his sole discretion and election, to purchase authorized by unissued shares of Computronics common stock (hereinafter referred to, and referred to in the Option Agreement, as "Executive Shares") in accordance with the following schedule: (Stip. Par. 17)

1.1.1. On or after August 1, 1984, but before February 1, 1985
Up to 6,618 shares.
1.1.2. On or after May 1, 1985, but before November 1, 1985
Up to 9,453 shares.
1.1.3. On or after May 1, 1986, but before November 1, 1986
Up to 14,610 shares.

The price for the shares to be purchased by the taxpayer pursuant to the Option Agreement was agreed upon in the amount of $5.00 per share (Stip. Par. 18) and, upon execution of the Option Agreement, Computronics acknowledged receipt from Keogh of the sum of $25,000.00 as payment for the stock options. (Stip. Par. 19)

By the terms of Paragraph 1.3 of the Option Agreement, the Option Payment was to be credited toward the purchase price of the Executive Shares in the form of credits of $5,000.00 toward the purchase price of Executive Shares purchased pursuant to Paragraph 1.1.1. of the Option Agreement; $10,000.00 toward the purchase price of Executive Shares purchased pursuant to Paragraph 1.1.2. of the Option Agreement; and $10,000.00 toward the purchase price of Executive Shares purchased pursuant to Paragraph 1.1.3. of the Option Agreement. (Stip. Par. 20)

However, on May 17, 1984, pursuant to the unanimous written consent of the Board of Directors of Computronics, Paragraph 1.1.1. of the Option Agreement was amended and modified to allow the taxpayer to exercise the first stage of options on or after May 17, 1984, but before February 1, 1985. (Stip. Ex. 32-F) (This Exhibit was also marked for identification as taxpayers' Exhibit 1 at the deposition of Gerald Libby held in California on March 8, 1990.) (Stip. Par. 23)

Taxpayer exercised his option on May 30, 1984, and 6,618 shares of common stock of Computronics were mailed to him on June 18, 1984, with a transmittal letter from Robert A. Andreani of Whitman and Ransom, counsel for Epson and Computronics. (See Stip. Par. 24, Ex. 33-AG; Stip. Par. 29, Ex. 34-AH); (Stip. Par. 31 Ex. 35-AI)

The aggregate purchase price for the 6,618 shares of common stock of Computronics pursuant to the Option Agreement and pursuant to petitioner's Notice of Exercise of Option was $33,090.00.

Computronics credited taxpayer with, and deducted from the aggregate price, the sum of $5,000.00, representing a portion of the Option Payment Credit, leaving a net purchase price for the 6,618 shares of $28,090.00.

Petitioner elected, in his Notice of Exercise of Option, to defer payment of the net purchase price of $28,090.00, and to have the net purchase price treated as Deferred Purchase Amount in accordance with Paragraph 1.3 of the Option Agreement. (Stip. Par. 27)

By the terms of Paragraph 1.3 of the Option Agreement, the Deferred Purchase Amount was to bear interest at the rate of six percent per annum, and was to be deducted, together with accrued interest, from the amount to be paid by Computronics in the event of its repurchase of the shares. (Stip. Par. 28)

Petitioner gave his receipt for Share Certificate No. 2, representing 6,618 shares of common stock of Computronics. (Stip. Par. 29, Ex. 34-AH)

Less than three years after entering into the contracts with Epson, Keogh was advised by Jack A. Whalen, Vice-President of Epson, by letter dated March 25, 1985, that Epson wished to restructure the twelve regional distribution corporations to become sales branch offices of Epson, and Epson advised that it would repurchase the shares of stock of Computronics which the taxpayer owned. (Stip. Par. 32, Ex. 36-AJ) The incentives in the incentive stock option had worked for Epson.

On March 29, 1984 the taxpayer was given official notice by Certified Mail, Return Receipt Requested, of the election by Computronics and Epson to repurchase all 6,618 shares of stock of Computronics owned by Petitioner pursuant to Paragraph 3.5 of the May 1, 1982 Option Agreement. (Stip. Par. 34, Ex. 38-AL)

A check dated June 27, 1985 in the amount of $1,414,365.00 payable to the order of Pat Keogh and drawn on the account of Epson America, Inc. at Citibank (Delaware Citicorp) was sent to the taxpayer in partial payment for his shares of stock. (Stip. Par. 40, 41, Ex. 44-AR)

Upon receipt of this check the taxpayer, on July 3, 1985, at CBT (Connecticut Bank and Trust Company), 10 Middle Street, Bridgeport, Connecticut, endorsed and assigned the 6,618 shares of stock before a witness and returned the certificate to Epson in California. (Tr. pp. 27-28) (Stip. Par. 51, Ex. 53-BH)

A second check in the amount of $655,830 dated August 27, 1985 was also sent to the petitioner. (Stip. Par. 42, 43, Ex. 45-AJ)

In the preparation of and prior to filing of taxpayers' 1985 joint federal income tax return the advice and counsel of an attorney was obtained, in writing, as well as the oral advice and counsel of

Kevin Byrne C.P.A., Coopers and Lybrand (Tr. pp. 36) that the sale of the stock by the taxpayers resulted in a capital gain. (Stip. Par. 73, Exs. 63-BK and 64-BL) The tax returns for the years in question were prepared by James Crozier, (Stip. Par. 74) and the taxpayer also relied upon the advice and counsel of Crozier in reporting the sale of his Computronics stock on Schedule D as a capital gain. (Tr. pp. 37)

## SUMMARY OF ARGUMENTS

At the trial the United States Tax Court refused to let the petitioner-taxpayers' expert witness testify on the grounds that Tax Court Rule 143(f) had not been complied with. After excluding the testimony of taxpayers' expert witness, who was to testify as to the fair market value of the price per share of the incentive stock option, the Tax Court erroneously held and the Second Circuit affirmed the holding that the taxpayers presented "no evidence" as to the fair market value of the stock as of the date of the option, May 1, 1982. The taxpayer presented an abundance of evidence as to the fair market value of the stock including the Option Agreement, which recited the price to be $5.00 per share, the Option Agreements of the other 11 distributors, who also paid $5.00 per share, or, to put it another way, the taxpayer presented evidence of 11 comparable sales, and proved there were no other sales. Taxpayer proved that he paid no more and no less than any of the other 11 Epson distributors for his stock option, and therefore paid the fair market value, not less than the fair market value, and thus complied with the provisions of Sec. 422A(b)(4).

Secondly, in the United States Court of Appeals for the Second Circuit, the Government, on brief, conceded that the taxpayer, Epson, and Computronics were dealing at arms-length in entering into the Option Agreement. Since arms-length sales are the best evidence of value, United States v. Music Master, Ltd. infra, the Second Circuit erred in upholding the Tax Court's decision that Taxpayer presented "no evidence" as to fair market value.

Thirdly, neither the Tax Court nor the Second Circuit ever determined the fair market value of the stock on May 1, 1982. The Statute, Sec. 422A(b)(4) states the price must be equal to or exceed the fair market value of the stock at the time the option was granted. But when no fair market value was ever determined either by the Tax Court or the Second Circuit, how can both Courts conclude the provisions of Sec. 422A(b)(4) were not met, when no fair market value was determined. The $5.00 per share price taxpayer paid was less than fair market value? By how much? What was fair market value? These are questions neither Court answered. This was a "closed end" transaction and according to this Court's decision in Burnet v. Logan, infra, and the decisions of other courts, it was incumbent upon the

Tax Court, the trier of fact, to determine fair market value in a "closed end" transaction. The Tax Court erred in failing to determine fair market value and the Second Circuit erred in affirming the Tax Court's decision.

Both the Tax Court and the Second Circuit erred when they failed to consider the provisions of Sec. 422A(c) in any meaningful way.

Lastly, the Tax Court has established two different rules of evidence with regard to testimony of expert witnesses, which rules of evidence are in conflict with themselves. First the Tax Court unequivocally tells its practitioners, as far as evidence is concerned, to follow the federal rules while, at the same time, it maintains Rule 143(f) regarding the testimony of expert witnesses. The primary difference is that the federal rules of evidence provide that all witnesses, including expert witnesses, must testify orally and in open court, but the Tax Court Rule, 143(f), provided that experts "testify" through written reports, that the written report is "substituted" for oral testimony in open court. Thus, Tax Court Rule 143(f) is in conflict with the other rules of evidence promulgated by the Tax Court, i.e. the federal rules of evidence and with Rule 43(d) of the federal rules of civil procedure as prescribed by this Court.

Consequently, when the taxpayer called his expert witness to the stand to testify he was adamantly prevented from doing so by the Tax Court. The Tax Court would not receive into evidence either the expert witness' oral testimony or his appraisal report in lieu thereof. The Tax Court erred in excluding this evidence.

Furthermore, Tax Court Rule 143(f) does not require the "testimony" of an expert witness in the appraisal report to be under oath, which is also contrary to the federal rules of evidence as prescribed by the Supreme Court.

Lastly, in enacting Sec. 422A of the Internal Revenue Code of 1954, as amended, Congress intended to give its citizens a tax break by according capital gain treatment to the proceeds from the sale of incentive stock options rather than having such proceeds taxed at ordinary income rates. In enacting Sec. 422A Congress defined what was and what was not an incentive stock option, and if the requirements set forth by Congress were met, then an incentive stock option existed, no matter what the agreement was labeled, no matter what the intent of the parties. Both the Tax Court and the Second Circuit erred in holding that language in the terms of the Repurchase Agreement regarding the tax consequences to Epson was determinative of whether or not an incentive stock option existed rather than looking at each of the requirements of Sec. 422(A) to

determine whether or not Congress' definition of an incentive stock option had been met or not. Furthermore, if the Second Circuit had looked at Sec. 5.7 of the Repurchase Agreement as requested by the taxpayer at oral argument, the Court would have found an agreement by and among the parties that the Option Agreement in question is expressly stated to be an incentive stock option.

## ARGUMENT

I.

A. THE TAX COURT AND THE SECOND CIRCUIT IN AFFIRMING ERRED IN HOLDING THAT THE TAXPAYERS PRESENTED NO EVIDENCE AS TO THE FAIR MARKET VALUE OF THE STOCK OF COMPUTRONICS AT THE TIME OF THE EXERCISE OF THE OPTION.

In its Opinion the Tax Court held that the taxpayer's stock option did not qualify as an incentive stock option under Section 422A(b)(4) since the taxpayers presented no evidence that the $5.00 per share price reflected the fair market value of the Computronics stock at the critical date, May 1, 1982, the time of the option.

The pertinent provisions of the Tax Court's Opinion are as follows:

OPINION

> Section 422A includes a number of requirements which must be met in order for an option issued thereunder to be recognized as an incentive stock option. Respondent argues that petitioner's option failed to meet the requirements of Section 422A(b)(1), (2), (4), and (8). For simplicity, we discuss principally Section 422A(b)(4).
>
> Section 422A(b)(4) requires that the option price of incentive stock option shares be not less than the fair market value of the stock at the time the option is granted. Petitioners presented no evidence as to the value of the shares at that time. Respondent's expert valued the shares at $16.01.
>
> However, we are not required in this case to determine the precise value of the shares of stock on

> May 1, 1982. It is quite clear on the facts before the Court that petitioner simply accepted the $5 price set forth in the option contract without any discussion or negotiation as to that price with Computronics or with Epson personnel. The $5 purchase price appeared in all 12 of the distribution agreements. There is no evidence that the $5 per share price was intended to represent the fair market value of the stock. Both Epson and Computronics intended the option to be part of the compensation package and the documents were presented to petitioner substan-tially on a "take it or leave it" basis. Since there is no evidence that either petitioner, Computronics, or Epson intended that this $5 per share price should reflect the market value of the shares of stock, we are required to hold for respondent on that issue. The stock option issued to petitioner does not qualify as an incentive stock option issued pursuant to Section 422A(b), since there is no evidence that the $5 price reflects fair market value on the critical date. (Emphasis added.)

Petitioners appeal the Tax Court's decision below, as well as that of the Second Circuit, on the grounds that the decision is clearly erroneous. The record in this case contains an enormous amount of both documentary and testimonial evidence as to the fair market value of the Computronics stock at the time of the option.

First, the United States Tax Court absolutely and unequivocally requires in Tax Court Rule 91, Title 26, U.S.C. Sec. 7453, Rule 91, that the parties stipulate and agree in writing to as many facts, documents, papers, and evidence which are not in dispute as exist, and once the stipulation has been executed by counsel for the parties and filed with the Court, these stipulated matters, for all practical purposes, become indisputable facts which are agreed to and accepted by the parties and the Court to be true and have a binding effect. (Tax Court Rule 91(e).)

In this case the parties executed and filed with the Tax Court a Stipulation of Facts which was 16 pages in length, contained 78 paragraphs, and approximately 66 documents were attached thereto as exhibits and incorporated into the Stipulation of Facts by reference. The petitioners maintain that this Stipulation of Facts and the exhibits attached thereto constituted evidence under Tax Court Rule 91(c) which states, in part "A stipulation when filed need not be offered formally to be considered in evidence."

Secondly, there was a trial of this case in Hartford, Connecticut on March 23, 1990 at which time the Stipulation of Facts

was jointly introduced into evidence by the parties and accepted by the Tax Court and both parties produced witnesses, and the testimony of these witnesses also constitutes evidence.

An examination of the Stipulation of Facts, the exhibits attached thereto and incorporated therein by reference, as well as the transcript of the witnesses' testimony at trial, reveals that the Tax Court's Opinion and Decision that the taxpayers "presented no evidence as to the value of the shares" is clearly erroneous.[3]

Specifically, what evidence was presented. The parties stipulated and agreed that the taxpayer entered into an Option Agreement with Epson and Computronics on May 1, 1982, and that a true copy of the Option Agreement was attached to the Stipulation as Exhibit 18-R. Epson entered into similar Option Agreements with each of its eleven other distributorship subsidiaries and those subsidiaries' presidents on May 1, 1982, and that true copies of their Option Agreements were set forth in the Stipulation as Exhibits 19-S through 19-AC to Paragraph 16 of the Stipulation. The parties further stipulated and agreed in Paragraph 18 of the Stipulation that the price for the shares to be purchased under the Option Agreement was $5.00 per share, and that the taxpayer paid Epson $25,000 cash as payment for the option. The price that the presidents of the eleven other Epson distributors paid was also $5.00 per share. These are indisputable, uncontested facts presented to the Tax Court as evidence which established or proved that the going price or the fair market value of the option or right to purchase Epson stock in the future was $5.00 per share as of May 1, 1982, the time the option was offered to and accepted by the taxpayer and the eleven other presidents of Epson distributorships. For the Tax Court to hold the taxpayer presented "no evidence" is clearly erroneous. The foregoing evidence was presented in the Stipulation which is of record.

In addition to the stipulated factual evidence there was testimonial evidence as well. At trial Keogh testified at length about the due diligence (he did not use the exact words "due diligence") he undertook to ascertain that $5.00 per share was the fair market value of the Epson stock as of May 1, 1982. This uncontradicted testimony[4] by Keogh constituted evidence presented by taxpayers and consisted of the following: (Tr. pp. 20-23)

KEOGH - DIRECT

Q. Okay, did they send to Mr. Babycos all three agreements, the option agreement, the distributorship agreement, and the employment agreement.

A. Yes, they did.

Q. Okay, did you know anybody in the organization from your days with Zenith or with Plymouth Electric in New Haven?

A. Yes, they had already contacted and hired two of my colleagues, one from the Boston distributorship, Mr. Tom Cavanaugh, and the Philadelphia distributor, Mr. Donald Schick –

Q. Okay.

A. – and I had conversations with both those gentlemen before I signed my agreement because they were already on board.

Q. Okay, I was going to ask you, did you have any discussions first of all with Mr. Babycos in connection with all three agreements?

A. Yes.

Q. Did you have any conversations with Gerald Libby?

A. Yes.

Q. And did Mr. Babycos confer with Mr. Libby?

A. Yes he did.

Q. Okay, were all three agreements considered, or sent to you as one particular package?

A. Yes, they were.

Q. Now, was the price of five dollars a share already in the agreement, or was that your suggestion that the price be five dollars a share:

A. The price of five dollars was already in the agreement.

Q. Okay, in other words it was offered to you at five dollars a share by Computronics?

A. Yes.

Q. Did you talk to anybody else in connection with the five dollars a share?

A. Yes, I spoke with Mr. Cavanaugh and Mr. Schick and they were offered the same plan and the same program at five dollars a share.

Q. Okay.

A. Before I signed my agreement I wanted to check it out. I was fifty years old at the time, I didn't want to make a move without checking thoroughly every portion of the agreement, as I was asked to invest $25,000.00 besides, which was a considerable amount of cash at that time in my life.

Q. How much was it at that time in your life?

A. It was just about all of my liquid savings –

Q. And was your –

A. – other than my home.

Q. Was your wife encouraging you to go into this new venture?

A. Discouraged me very much so. She was very skeptical about the whole situation.

Q. And did you talk to Cavanaugh and Schick about the price of five dollars a share?

A. Yes I did.

Q. And did you satisfy yourself that five dollars a share appeared to be a good price?

A. Well, it was the only price that was offered, so I felt that, you know, it was a calculated risk and I was willing to assume that risk; however, the gentleman who was going to take my position before that had stopped in Chicago on his way to L.A. to a first meeting and decided that it wasn't worth the risk and decided to quit there on the spot and flew back from New York after he called his wife and spoke with his wife's brother who was an attorney and he discouraged him from taking that risk and he flew back to New York, this I know for a fact, and he refused to take the contract and the assignment.

The Stipulation of Facts contains additional evidence showing taxpayer's interest in the fair market value and his $5.00 per share investment in Epson's stock options before he signed the Option Agreement.[4] For example, taxpayer was concerned what would happen to his $5.00 per share investment in the stock options in the event Epson contributed more capital to Computronics. In short, he did not want his investment "watered down." Consequently, an addendum was entered into between Epson and the taxpayer which provided for additional incentive stock options to Keogh in the event of further capital contributions by Epson. (Stip. Par. 21, Ex. 30-AD) This is evidence that pertains to the fact that $5.00 per share was fair market value.

In the Stipulation of Facts (Par. 23, Ex. 32-AF) the Option Agreement was modified (and ratified) by the unanimous written consent of the Board of Directors of Computronics to allow Keogh to exercise the first stage of his option in advance of the schedule set forth in the original Option Agreement. In the unanimous consent (pp. 3) the $5.00 per share purchase price for the stock was reiterated and affirmed by the Board of Directors of Computronics. This is evidence as to the stock's fair market value.

The deposition of Jack Whalen was taken in California (Stip. Par. 77, Ex. 65-BM) and he testified his conversations with Keogh (and the other eleven distributors) involved, in part, the $5.00 per share price for the option.[5]

Respondent through invalid Treasury Regulations[6] would have had Mr. Keogh obtain two or more written appraisal reports of the Computronics stock. Although prudent, businessmen do not usually do this. What was there to appraise? Computronics was a brand new Delaware corporation with no assets or track record other than the $375,000 contributed to capital by Epson in exchange for 37,500 shares or $10.00 per share.

What Keogh received on May 1, 1982 was an incentive from Epson America, Inc. in the form of an option to purchase shares of authorized by as yet unissued stock on or after August 1, 1984, but before February 1, 1985, some two years or so down the road. Many things had to happen. Epson had to survive and still be in business. Computronics had to survive and still be in business. Keogh had to survive and still be employed by Epson. The taxpayer had to meet all the sales goals and requirements of all his contractual obligations, and, of course, Epson had to have done well enough financially that the taxpayer would still be interested in exercising his option and purchasing the stock, and then have a market to resell the small minority interest in the Computronics stock he purchased. Keogh barely had the $25,000 option money in 1982. He testified that it took all his liquid assets. He had nothing left over to spend or waste on two appraisal reports for a shell of a company.

So he did the next best thing to determine the stock's fair market value. He talked to everyone he could who was involved and obtained their opinions and reasoning. He talked to his attorney, Babycos, he talked to Gerald Libby and Jack Whalen, both from Epson, he talked to Cavanaugh and Schick, both of whom he knew previously from prior employment and who had signed on with Epson. He flew to California and talked to Tashiro Tsubota, the president of Epson America (Tr. pp. 17) and he had more discussions with Whalen and Tsubota at a computer trade show in Houston. (Tr. pp. 18) He ascertained that the price was $5.00 to all of the distributorship presidents. He wasn't paying any more or any less than anyone else. He wasn't paying top dollar or getting a bargain or purchasing his options at less than the going rate or fair market value that the options were offered to everyone else involved. Taxpayer ascertained there were 11 other comparable sales. The taxpayer did his homework and had to because, as he testified, his spouse was very reluctant for him to enter into the deal with Epson and the deal was taking all of his cash. The taxpayer even knew that he wasn't Epson's first choice for the New York area, and that Epson's first choice had elected not to enter into the deal. How much due diligence is enough? The taxpayer did as much due diligence as he could, as much as it took to make him satisfied that he was paying no more and no less than the other 11 Epson distributors or fair market value, and then he signed the agreements. This was a private

transaction and the taxpayer only had to do enough due diligence to satisfy himself (and his spouse) and no one else.

The Tax Court's opinion and conclusion, affirmed by the Second Circuit, that the taxpayer presented no evidence as to the fair market value of the stock at the time the Option Agreement was executed is clearly erroneous. (T.C. Op. pp. 6)

B. THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT ERRED WHEN IT FAILED TO NOTE THAT THE RESPONDENT HAD CONCEDED FAIR MARKET VALUE ON BRIEF.

In the Brief filed by the respondent in the United States Court of Appeals for the Second Circuit, the respondent, on brief, conceded as follows: (Br. pp. 21)

> While the Commissioner does not disagree that taxpayer, Epson, and Computronics were dealing at arms- length in entering into the Option and Employment Agreements, the Tax Court correctly found that 'there is no evidence that the $5 per share price was intended to reflect the stock's fair market value.' (Tax Ct. Op. at 6) (Emphasis added)

In United States v. Music Master, Ltd. 621 F. Supp. 1046, (D.C.N.C., 1985) the Court defined fair market value as follows: (pp. 1055)

> ...The definition most often used in tax cases to determine "fair market value" is "the price at which property would exchange hands in a transaction between a willing buyer and a willing seller, neither being under a compulsion to buy nor sell and both being reasonably informed as to all relevant facts. (Emphasis added) See Goldstein v. Commissioner, 298 F.2d 562 (9th Cir. 1962) and O'Malley v. Ames, 197 F.2d 256 (8th Cir. 1952) See also 10 Mertens Law of Federal Income Taxation (1984 revised ed) Sec. 59.01, et seq.

Likewise, in the same case the Court further held: (pp. 1054)

> Arm's length sales are, other things being equal, the best evidence of the value of the assets of a business. Gravois Planning Mill Co. v. Commissioner, 299 F.2d

199 (8th Cir. 1962); Grill v. United States, 303 F.2d 922, 157 Ct. Cl. 804 (1962)

Consequently, since the respondent conceded on brief in the United States Court of Appeals for the Second Circuit that the parties were dealing at arm's length, and since arm's length sales are the best evidence of fair market value, it was incumbent upon the Second Circuit to determine that the $5.00 per share price arrived at in the concededly arm's length dealings between Epson, Keogh, and Computronics was the fair market value of the incentive stock options. This the Second Circuit failed to do.

II.

A. NEITHER THE TAX COURT NOR THE SECOND CIRCUIT EVER MADE A DETERMINATION AS TO THE FAIR MARKET VALUE OF THE STOCK AT THE TIME THE OPTION AGREEMENT WAS EXECUTED. CONSEQUENTLY, THERE WAS NO HOLDING BY THE TAX COURT OR THE SECOND CIRCUIT THAT THE PRICE PAID WAS LESS THAN FAIR MARKET VALUE.

In its Opinion below the Tax Court never rendered an opinion as to the fair market value of the stock at the time the option was granted, May 1, 1982. The Tax Court never determined a value for the price per share of the taxpayers' stock option. The Tax Court in fact held:

> However, we are not required in this case to determine the precise value of the shares of stock on May 1, 1982. (Emphasis added.)

The Tax Court never determined the value of the shares of stock on May 1, 1982 or at any other time, nor did the Second Circuit.

The statute itself, Section 422A(b)(4) provides that the option price must be equal to or exceed the fair market value of the stock at the time the option was granted. In other words it cannot be a bargain or less than fair market value. Since there was no determination by the Tax Court or the Second Circuit of the fair market value of the stock at the time the option was granted, there is no way it can be said that the price of $5.00 per share, or any other price, was either more or less than the fair market value of the stock at the time the option was granted. There is no price that can be compared. If the Tax Court had put a value on the stock at the time the option was granted, then there would be a basis of comparison. For example, if the Tax Court held the value to be $4.00 per share,

then $5.00 per share could be compared for the purpose of satisfying the requirements of Section 422A(b)(4). The same would be true if the Tax Court had determined that the stock had a value of $100.00 per share at the time the option was granted to the taxpayer. But, in this case the Tax Court (and the Second Circuit) made no determination whatsoever as to the fair market value of the Computronics stock at the time the option was granted to the taxpayer. So how can it be said that the taxpayer did not satisfy the requirements of Section 422A(b)(4)? How can it be said, as the Tax Court and Second Circuit held, that the taxpayer did not pay fair market value for his stock option when no fair market value was ever determined by the Tax Court or the Second Circuit?

The taxpayer maintains that he proved and the evidence of record fully supports the fact that he paid valid consideration of $5.00 per share in an arm's length transaction for the option to purchase the stock of Computronics. This is indisputable. Since there was no determination by the Tax Court or the Second Circuit as to the fair market value per share, it is impossible to conclude the taxpayer did not satisfy the requirements of Section 422A(b)(4) as determined by the Tax Court and Court of Appeals in their Opinions. Whether the option price taxpayer paid was fair market value, more than fair market value or less than fair market value was never determined by either the Tax Court or the Second Circuit. For this reason alone the Courts' decisions below were erroneous and should be reversed.

B. BOTH THE TAX COURT AND THE SECOND CIRCUIT WERE OBLIGATED BY THE DECISIONS OF THIS COURT, OTHER COURTS AND THE STATUTE ENACTED BY CONGRESS TO DETERMINE FAIR MARKET VALUE, WHICH THE COURTS FAILED TO DO.

As previously noted the Tax Court held "However, we are not required in this case to determine the precise value of the shares of stock on May 1, 1982." This holding by the Tax Court was erroneous. The evidence clearly revealed the purchase price for the incentive stock options was $5.00 per share. Sec. 422A(b)(4) clearly provides that to be an incentive stock option the purchase price must be fair market value, i.e. it cannot be a bargain price. Since the Tax Court never determined a fair market value for the stock option, it was impossible for the Tax Court to conclude that the $5.00 purchase price was not fair market value.

In Gersten v. C.I.R. 267 F.2d 195 (at pp. 199) the Ninth Circuit held that it was incumbent upon the Tax Court to fix a definite amount as to the fair market value, and the Court's failure to do so required the case to be remanded back to the Tax Court for further proceedings. The Ninth Circuit held: (pp. 199) "The responsibility

of the Tax Court was to fix a definite amount as the fair market value."

In McCormac v. United States, 424 F.2d 607 (Ct. Cl., 1970) the Court of Claims noted the Internal Revenue Service's own position regarding valuation and fair market value as follows:

> Contracts and claims to receive indefinite amounts, such as those received in exchange for stock in liquidation of a corporation, must be valued for Federal income tax purposes except in rare and extraordinary cases. (Emphasis added) Rev. Rul. 58-402; 1958-2 C.B. 15.

This Court has also held that it is incumbent upon the trier of fact to determine a value when the question of fair market value is at issue. Burnet v. Logan, 283 U.S. 413; 51 S.Ct. 552; 75 L.Ed. 1143 (1931); See also Marsack's Estate v. Commissioner of Internal Revenue, 288 F.2d 533 (7th Cir. 1961)

The irony of the Second Circuit's opinion is that in citing Victorson v. CIR, 326 F.2d 264, 267 (2nd Cir. 1964) the Court cited a case that substantiates the position of the taxpayer in that Victorson, supra, was a tax case involving a fair market value issue in which the Tax Court actually determined a fair market value, whereas in the instant case the Tax Court failed to determine a fair market value and concluded that there was no requirement for it to do so. In short, the Second Circuit failed to follow its own precedents, Victorson, supra, being one of them, and Richardson v. Commissioner of Internal Revenue, 151 F.2d 102 (2nd Cir. 1945) being another.

III.

THE TAX COURT AND SECOND CIRCUIT ERRED WHEN THEY FAILED TO ADOPT FINDINGS OF FACT AND CONCLUSIONS OF LAW OR OTHERWISE CONSIDER SECTION 422A(c) OF THE INTERNAL REVENUE CODE

On brief in the United States Tax Court below, the taxpayer argued and urged the Tax Court to consider the Special Rules provision of Section 422A(c)(1) which states as follows:

(c) Special Rules

(1) Good faith efforts to value stock

> If a share of stock is transferred pursuant to the exercise of an option which would fail to

> qualify as an incentive stock option under subsection (b) because there was a failure in an attempt, made in good faith to meet the requirement of subsection (b)(4), the requirement of (b)(4) shall be considered to have been met. To the extent provided in regulations by the Secretary, a similar rule shall apply for purposes of subsection (b)(8).

In its Opinion below the Tax Court never considered the provisions of Section 422A(c)(1) in any way. It was never mentioned in the Tax Court's Opinion and there never was findings of fact or conclusions of law regarding this issue.

In its Opinion the Tax Court held that the taxpayer did not satisfy the requirements of Section 422A(b)(4) since he did not prove that the option price was not less than the fair market value of the stock at the time the option was granted. Assuming arguendo, that was the case, once the Tax Court determined the provisions of (b)(4) were not met, it was incumbent upon both the Tax Court and the Second Circuit to look to the provisions of Section 422A(c)(1), and determine if the Special Rules of this section of the Code applied. This was not done by either the Tax Court or the Second Circuit.

Taxpayers maintain the Tax Court and Court of Appeals erred in not rendering an opinion or decision concerning Section 422A(c)(1), because by statute it was incumbent upon them to do so, and it was put into issue in both the Tax Court and Second Circuit below, and argued by both parties on brief. Thus, this case should be reversed because of both Courts' failure to consider Section 422A(c)(1).

## IV.

### A. THE SUPREME COURT OF THE UNITED STATES AND COURTS ESTABLISHED BY ACTS OF CONGRESS ARE ENTITLED TO ESTABLISH THEIR OWN RULES FOR THE CONDUCT OF THEIR BUSINESS.

Title 28 U.S.C. Sec. 2071, Appendix A, infra, specifically provides that the Supreme Court and all courts established by Act of Congress may from time to time prescribe rules for the conduct of their business. The Supreme Court has prescribed such rules and in civil cases they are commonly known as the Federal Rules of Civil Procedure for the United States District Courts and the Federal Rules of Evidence for United States Courts and Magistrates.

The United States Tax Court is not an Article III or Constitutional Court, but one established by an Act of Congress, Title

26, U.S.C. Sec 7441, Appendix A, infra, and as such is duly authorized and empowered by Title 28 U.S.C. Sec. 2071, Appendix A, infra, to prescribe and promulgate its own rules for the conduct of its business.

The United States Tax Court has, in fact, promulgated its own rules of practice, procedure and evidence, the pertinent provisions of which are set forth in Title 26 U.S.C. Sec. 7453; Title 26 U.S.C. Sec. 7453, Rule 1; and Title 26 U.S.C. Sec. 7453, Rule 143(a) and (f), Appendix A, infra.

Thus, it is clear that as far as practice and procedure are concerned, the Tax Court has prescribed its own rules, "(other than rules of evidence)," but as far as evidence is concerned the Tax Court has prescribed that trials are to be conducted "in accordance with the rules of evidence applicable in trials without jury in the United States District Court of the District of Columbia," Sec. 7453 and... "To the extent applicable to such trials, those rules include the rules of evidence in the Federal Rules of Civil Procedure and any rules of evidence generally applicable in the Federal Courts (including the United States District Court for the District of Columbia." Rule 143(a).

B. THE TAX COURT'S RULES ARE IN CONFLICT WITH THEMSELVES

It is respectfully submitted that the Tax Court's rules are in conflict with themselves. Once the Tax Court prescribed the rules of evidence to be that of the United States District Court of the District of Columbia, and, where applicable, the rules of evidence in the Federal Rules of Civil Procedure, and any rules of evidence generally applicable in the Federal Courts, it should have stopped. The rules were prescribed. However, the Tax Court went on to prescribe Rule 143(f) entitled Expert Witness Reports. The requirements of Rule 143(f) are not found in the evidentiary rules the Tax Court previously prescribed, namely the rules of the United States District Court of the District of Columbia, the Federal Rules of Civil Procedure, the Federal Rules of Evidence, or any rules of evidence generally applicable in the Federal Courts.

Consequently, the Tax Court has established two separate evidentiary rules regarding expert witnesses which are in conflict with one another.

C. RULE 143(f) CONFLICTS WITH THE RULES OF EVIDENCE OF THE UNITED STATES DISTRICT COURT OF THE DISTRICT OF COLUMBIA, THE FEDERAL RULES OF CIVIL PROCEDURE, AND THE RULES OF EVIDENCE GENERALLY APPLICABLE IN FEDERAL COURTS.

When the United States Tax Court prescribed "the rules of evidence applicable in trials without a jury in the United States District Court of the District of Columbia" and... "To the extent applicable to such trials, those rules include the rules of evidence generally applicable in the Federal Courts"...the Tax Court did not prescribe rules of evidence of some exotic court which were different from those of the Federal Rules of Civil Procedure and the Federal Rules of Evidence.

Although historically once known as the Supreme Court for the District of Columbia, the United States District Court of the District of Columbia is now just another United States District Court, no different than the United States District Court for the Southern District of New York. See Title 28, U.S.C. Sec. 88, Appendix A, infra.

As such a United States District Court it is subject to the rules prescribed by the Supreme Court of the United States of practice and procedure and rules of evidence for cases in the United States district courts and courts of appeals. See Title 28, U.S.C. Sec. 2072(a), Appendix A, infra.

A perusal of Rule 143(f) and the Federal Rules of Civil Procedure and the Federal Rules of Evidence clearly reveals that none of the requirements and punitive provisions of Tax Court Rule 143(f) are to be found in the Federal Rules. For example, in 1990, at the time of the trial of this case, the Federal Rules did not require that the party who calls an expert witness must cause that witness to prepare a written report for submission to the Court and to the opposing party.[7] Tax Court Rule 143(b) provides that the written report must set forth the expert's qualifications, state his opinions and the facts or data on which the opinion is based, and the reasons for the conclusion. The Federal Rules do not state that the report itself is to be marked as an exhibit, identified by the witness, and received in evidence as the direct testimony of the expert witness, unless the Tax Court determines he is not qualified as an expert.

Furthermore, in the Federal Rules in 1990 there was no fifteen (15) day time requirement for submitting the expert witness report to the Court and to the opposing party, or any punitive rule for excluding the expert witness' testimony altogether for failure to comply with the provisions of Rule 143(f).

The Federal Rules of Evidence prescribed by the Supreme Court regarding the testimony of an expert witness are much different than Rule 143(f) prescribed by the Tax Court. One of the most significant and conflicting differences is the form of the testimony.

The Federal Rules of Civil Procedure make it abundantly clear in Rule 43(a) that an expert witness' report cannot be considered the direct testimony of the expert witness. He must testify. Rule 43(a) states:

> RULE 43. TAKING OF TESTIMONY
>
> (a) Form. In all trials the testimony of witnesses shall be taken orally in open court, unless otherwise provided by an Act of Congress or these rules, the Federal Rules of Evidence, or by rules adopted by the Supreme Court. (Emphasis added.)

In addition to Rule 43(a), Rule 611 of the Federal Rules of Evidence, Appendix A, infra, sets forth the mode and order of interrogation of witnesses and presenting evidence, and Rule 614, Appendix A, infra, allows the Court to call and interrogate witnesses. However, there is no doubt that the form of taking testimony is to be done orally, in open court, by interrogation, and not by way of a written report.

In the absence of the oral interrogation of a witness in open court, all of the other rules of evidence, which are designed to help the trier of fact arrive at the truth, such as the proper form of the question, whether or not a proper foundation for the question and response has been laid, etc. are all obviated.

The primary purpose of taking the oral testimony of a witness in open court is to ascertain the truth. In this fashion the trier of fact can see, hear and otherwise observe the witness, take notice of his demeanor, how he presents himself, the manner in which he responds to direct and cross-examination, and in this fashion try to determine the accuracy and truthfulness of his testimony. How can this be done from a report?

Under the Federal Rules of Civil Procedure and the Federal Rules of Evidence each party has the right to cross-examine any witness, whether an expert witness or not, and cross examination is limited to the subject matter of direct examination. However, under Rule 143(f) once the expert witness' report has been marked as an exhibit and identified by the expert witness as his report, and the witness is accepted as an expert by the Tax Court, the report itself is automatically received into evidence as the direct testimony of the expert witness. Theoretically, the expert witness may not even be asked any questions about the merits of his report on direct examination, yet he has "testified" through his report. How does one cross-examine if there is no direct examination? How do you cross-examine a report?

The Federal Rules of Evidence regarding opinion testimony and the testimony of expert witnesses are set forth in Title 28, U.S.C. Rules 701-706, Appendix A, infra. With regard to the disclosure of facts or data underlying the expert witness' opinion Rule 706 states:

> Rule 706. Disclosure of Facts or Data Underlying Expert Opinion.
>
> The expert may testify in terms of opinion or inference and give his reasons therefor without prior disclosure of the underlying facts or data, unless the court requires otherwise. The expert may, in any event, be required to disclose the underlying facts or data on cross-examination. (Emphasis added.)

The Federal Rules of Evidence once again differ and conflict with Rule 143(f) in that they leave the parties to the discovery procedure of Rule 26(b)(4) and to cross examination to ascertain the underlying facts or data of the expert's opinion.

D. THE TAX COURT ERRED IN NOT ALLOWING THE TAXPAYER'S EXPERT WITNESS, S. JOHN MALINOWSKI, TO TESTIFY IN THAT IT UTILIZED A RULE OF EVIDENCE WHICH WAS NULL AND VOID AND OF NO FORCE AND EFFECT TO EXCLUDE TESTIMONIAL EVIDENCE AND IT ABUSED ITS DISCRETION IN DOING SO.

At the time of trail in Hartford, Connecticut on March 23, 1990 the taxpayer called as his first witness one who was to be his expert witness, S. John Malinowski, who was to testify as to the fair market value of the stock at the time the option was granted to the taxpayer, May 1, 1982. The taxpayer was prepared to proceed with his expert witness in accordance with the federal rules of evidence because the Tax Court had adopted the federal rules of evidence as its own rules of evidence.[8] Under Rule 43 of the Federal Rules of Civil Procedure, Title 28 U.S.C. Rule 43 states: "In all trials the testimony of witnesses shall be taken orally in open court—". That is why taxpayer's witness was present in the courtroom the day of trial all prepared, ready, able, and willing to testify in open court. The Tax Court refused to allow him to testify on the grounds that his expert witness appraisal report was not timely exchanged with respondent in accordance with the time provided by Tax Court Rule 143(f).

Thus, the first question is whether testimony and particularly expert witness testimony, involves evidence or procedure. The answer seems obvious. Testimony is normally considered evidence. Are the rules which exclude certain testimony, for example, hearsay, rules of procedure or rules of evidence? Is Rule 43, Federal Rules of Civil Procedure, which involves the form of taking testimony, one of

evidence or procedure? Again, since testimony is evidence, the rule for the form in which testimony is taken, orally and in open court, is a rule of evidence and not one of procedure. Indeed, prior to the enactment of the Federal Rules of Evidence in 1972, Rule 43, now entitled TAKING OF TESTIMONY was entitled RULES OF EVIDENCE. In 1972 subsections (b) and (c) of Rule 43 were transferred to the then new federal rules of evidence, Title 28 U.S.C. 701, et seq., and Rule 43 was relabeled TAKING OF TESTIMONY. See Title 28 U.S. C.A. Rule 43, Supplementary Note on Advisory Committee regarding Rule 43 and 44:

> 1972 Amendment Rule 43 entitled Evidence, has heretofore served as the basic rule of evidence for civil cases in federal courts. It's very general provisions are superseded by the detailed provisions of the new Rules of Evidence. The original title and many of the provisions of the rule are, therefore, no longer appropriate.

Consequently, from an historical point of view testimony and the form in which it must be taken, orally and in open court, has been a rule of evidence.

The Tax Court's rule regarding the taking of expert witness testimony is quite different. The Tax Court does not follow Rule 43. In the Tax Court the form of taking the testimony of expert witnesses is not orally and in open court, but by way of a written report, and the report itself is accepted into evidence by the Court as the testimony of the expert witness, once he or she has been qualified and accepted by the Tax Court as an expert witness. Therein lies the basis for determining Tax Court Rule 143(f) is null and void, and the use of it by the Tax Court to exclude the testimony of taxpayer's expert witness, S. John Malinowski, was erroneous.

There is no question that the Tax Court can promulgate any rules of practice, any rules of procedure, or any rules of evidence that it pleases. And it has done so. With regard to practice and procedure it has promulgated its own rules. Title 26 U.S.C. Sec. 7453. With regard to evidence, however, the Tax Court has promulgated two different rules of evidence which are in conflict with one another.

The Tax Court has stated on three separate occasions that as far as the rules of evidence are concerned trials in the Tax Court are to be conducted "in accordance with the rules of evidence applicable in trials without a jury in the United States District Court of the District of Columbia," and "to the extent applicable to such trials, those rules include the rules of evidence in the Federal Rules of Civil Procedure and any rules of evidence generally applicable in the

Federal Court, including the United States District Court of the District of Columbia." (1) Title 26 U.S.C. Sec. 7453; (2) Title 26 U.S.C. Sec. 7453, Rule 1; and (3) Title 26 U.S.C. Sec. 7453, Rule 143(a)(1).

With these rules of evidence in mind the taxpayer went into the Tax Court at the time of trial of this case with the understanding that the federal rules of evidence applied. Under the federal rules which existed in 1990, the time of trial, there was no requirement that a party had to cause his expert witness to write a written report setting forth his qualifications to be an expert witness, or to set forth in writing his opinion as to fair market value of property and the basis for such an opinion, or to exchange this report with the opposing party for a copy of the opposing party's appraisal report, or to file a copy of the report with the Court prior to trial.

Under the federal rules of evidence and the federal rules of civil procedure which pertained to evidence and to the testimony of expert witnesses in 1990, it was possible that neither party had any written appraisal report of an expert witness. If such a report did exist it was incumbent upon the opposing party to obtain it by utilizing the discovery procedure set forth in Rule 26 of the Federal Rules of Civil Procedure. Under the federal rules of evidence and civil procedure that existed in 1990 the appraisal report itself was not evidence. The only evidence would be the testimony that came out of the mouth of the expert witness orally, in open court, on direct examination of the witness under Rule 43 of the Federal Rules of Civil Procedure, and thereafter on cross-examination.

Under the federal rules that existed in 1990 the sole purpose for the opposing party obtaining a copy of any expert witness report that may have existed was for the purpose of allowing the opposing party to anticipate the expert witness' oral testimony in open court, and to prepare for any cross-examination of such expert witness.

Furthermore, under the federal rules that existed in 1990 there was no requirement that expert witness reports be exchanged within a certain number of days prior to trial; there was no federal rule that the report itself would constitute the testimony of the party's expert witness; and there was no federal rule that unless appraisal reports were timely exchanged a party could not call an expert witness at the time of trial and elicit his testimony. These were the federal rules pertaining to evidence that the Tax Court itself adopted and they were the rules the taxpayer and his counsel had in mind at the time of trial.

However, at the time of trial when the taxpayer's expert witness was called to the witness stand and sworn in, the Tax Court refused to let him testify, citing Rule 143(f). It was at this point that it became apparent the Tax Court had two separate and distinct rules

pertaining to evidence which were, and still are, in conflict with themselves.

If you followed the federal rules of evidence as instructed by the Tax Court, the rules provided that the form of the testimony of all witnesses, including expert witnesses, had to be oral and in open court, under Rule 43 of the Federal Rules of Civil Procedure. The appraisal report of the expert witness did not constitute his testimony. It was what he said orally in open court that constituted his testimony. Under the second rule adopted and promulgated by the Tax Court, Rule 143(f), the exact opposite was true. The oral testimony of the expert witness in open court meant virtually nothing. What was of significance and what was received in evidence as his testimony was his written appraisal report.[9] The written appraisal report meant everything as far as testimonial evidence was concerned notwithstanding the fact that it was in a form of testimony that was not only inconsistent but almost the exact opposite of Rule 43 of the Federal Rules of Civil Procedure. Thus, after following the federal rules of evidence the taxpayer found himself at the time of trial unable to offer into evidence the oral testimony in open court of his expert witness under Rule 43, nor was the taxpayer allowed to offer into evidence the written report of his expert witness in lieu of his oral testimony under Tax Court Rule 143(f). The Tax Court adamantly refused to accept either form of expert witness testimony and in doing so abused its discretion in a way which resulted in a miscarriage of justice.[10] (Tr. pp. 5-7)

Although the federal rules of evidence and the federal rules of civil procedure do not require it, the written reports of both expert witnesses were in fact exchanged before trial, and Regional Counsel for the Internal Revenue Service was advised of the name, address, telephone number and qualifications of taxpayer's witness, his opinion, and the basis therefore at least three days before trial, which was more than sufficient time to prepare for cross-examination. Further, the Tax Court neither requested nor obtained from Regional Counsel a showing of exactly why three days was not sufficient time for preparation of cross-examination, and it was error for the Tax Court not to so inquire.

Secondly, Tax Court Rule 143(f) is definitely in conflict with the other rules of evidence prescribed by the Supreme Court, and because of this conflict should be deemed null and void and of no force and effect under Title 28 U.S.C. Sec. 2072(b). This case should be reversed because the Tax Court rendered an evidentiary decision on the basis of Rule 143(f) which, because of its conflict with the other rules promulgated by the Supreme Court, is null and void and of no force and effect.

It is true that in 1993 the discovery rules of the Federal Rules of Civil Procedure, particularly Rule 26(a)(2), was changed to provide for the exchange of expert witness reports. However, this case was tried in 1990 and decided in 1992, long before the 1993 rule change.

At one time, apparently before the enactment of the Federal Rules of Civil Procedure and Rule 43, the Patent Office had the same form for the taking of testimony of expert witnesses, i.e. written reports, but has long ago abandoned the written report form of taking testimony in favor of the oral form, in open court, in conformity with the provisions of Rule 43 of the Federal Rules of Civil Procedure and Federal Rules of Evidence. Sec. 28 U.S.C.A. Rule 43, Advisory Committee Notes, 1937 Adoption, Note to Subdivision A.

## E. TAX COURT RULE 143 DOES NOT REQUIRE EXPERT WITNESS TESTIMONY TO BE UNDER OATH, WHICH IS ALSO CONTRARY TO THE FEDERAL RULES OF EVIDENCE

Lastly, before leaving the subject of Rule 143(f) the taxpayers wish to note that there is no requirement in Rule 143(f) that the expert witness report be under oath or sworn to or affirmed in any way. Appraisal reports are therefore usually never under oath because there is no requirement to do so.[11]

The result of all this is that under Rule 143(f) testimony is received into evidence by the Tax Court which is not under oath. Since such testimony is not under oath an individual can state anything in writing in the expert witness report, including false and misleading statements, and never have to worry about any punitive sanctions from a Court for telling outright lies, etc. This again is contrary to the Federal Rules of Civil Procedure as set forth in Rule 43(d), Title 28 U.S.C. Rule 43(d) and the Federal Rules of Evidence, Title 28 U.S.C. Rule 603, which states:

> Rule 603. Oath or Affirmation
>
> Before testifying, every witness shall be required to declare that he will testify truthfully, by oath or affirmation administered in a form calculated to awaken his conscience and impress his mind with his duty to do so.

Because Tax Court Rule 143(f) does not require testimony in the form of written reports to be under oath this is yet another reason to declare it null and void and of no force and effect, since it is contrary to the rule promulgated by the Supreme Court in Title 28 U.S.C. Rule 603, supra, and in Title 28 U.S.C. Rule 43(d).

F. TAXPAYERS' RELIANCE UPON THE FEDERAL RULES OF CIVIL PROCEDURE AND THE FEDERAL RULES OF EVIDENCE IS "GOOD CAUSE" FOR NOT STRICTLY ADHERING TO RULE 143(f).

In the alternative, assuming arguendo, Tax Court Rule 143(f) is deemed valid, it is submitted that taxpayers' reliance upon the Federal Rules of Civil Procedure and the Federal Rules of Evidence is "good cause" or reasonable cause for not strictly adhering to the punitive time requirements of Rule 143(f). The latter states, in part:

> ...An expert witness' testimony will be excluded altogether for failure to comply with the provisions of this paragraph, unless the failure is shown to be due to good cause and unless the failure does not significantly impair the opposing party's ability to cross-examine the expert witness or by denying the opposing party the reasonable opportunity to obtain evidence in rebuttal to the expert witness' testimony. (Emphasis added.)

The taxpayers relied upon the federal rules of evidence specifically prescribed by the Tax Court and by the Supreme Court. Reliance upon such rules was reasonable, and was "good cause" for not excluding the testimony of taxpayers' expert witness. Viewed in this light the case should be reversed and remanded.

V.

BY ENACTING SEC. 422A OF THE INTERNAL REVENUE CODE OF 1954, AS AMENDED, CONGRESS DEFINED THE TERM "INCENTIVE STOCK OPTION" AND THE LABEL ATTACHED TO AN INCENTIVE STOCK OPTION OR THE INTENT OF THE PARTIES WAS OF NO CONSEQUENCE ON MAY 1, 1982, THE DATE THE INCENTIVE STOCK OPTION WAS ENTERED INTO.

It is respectfully submitted that when Congress enacted Sec. 422A of the Internal Revenue Code of 1954, as amended, Congress and Congress alone defined the term "incentive stock option" and stated that if the requirements of Sec. 422A were met, then it was an incentive stock option no matter what label was given the option agreement by the parties or what their intent was. For example, two parties to an option agreement could label the agreement "Incentive Stock Option" and specifically state in the agreement that it was intended to be an incentive stock option under Sec. 422A of the Code. However, if the written document failed to meet the definition of an incentive stock option as defined by Congress in Sec. 422A, then it

simply wasn't an incentive stock option, no matter what it was labeled and no matter what the express intent of the parties to the agreement was. If the agreement failed to meet the requirements of Sec. 422A, it failed to meet the incentive stock option requirements set forth by Congress and it would fail to receive the favorable capital gains treatment accorded incentive stock options.

On May 1, 1982, the date the Option Agreement in question was executed, the reverse of the foregoing was also true. If the agreement met the requirements of Sec. 422A of the Code, it didn't matter what the agreement was labeled or what the parties intended. They had, in fact, created an incentive stock option under the definition set forth by Congress in Sec. 422A.

On brief in the Tax Court the Government conceded by not arguing the merits of most of the provisions of Sec. 422A. Only four subsections of Sec. 422A were left for the Tax Court's determination, but the Tax Court only discussed Sec. 422A(b)(4) and nothing else.

Both the Tax Court and the Second Circuit decided the case based upon the intent of the parties as determined from a paragraph in the Option Agreement regarding taxes. This tax clause stated that the amounts paid to the taxpayer upon the repurchase of his Computronics stock would be treated by Computronics as an ordinary and necessary business expenses for federal tax purposes and that the taxpayer would take no position to the contrary.

There is no question that the language employed in Par. 3.7 of the Option Agreement described only one facet of the tax consequences, that which involved Epson. But it is exactly describing only one side of the coin and not the other, which shows that there was no real meeting of the minds on tax treatment. If Par. 3.7 of the Option Agreement had clearly spelled out and stated to the taxpayer in plain English that (1) he was legally entitled to report the gain on the sale of his stock on Schedule D and receive much more favorable capital gains treatment instead of ordinary income treatment, and (2) that in executing the Option Agreement he was agreeing to waive this right to capital gain treatment and instead, (3) to pay taxes at ordinary income rates, and all his rights and the consequences of waiving those rights were fully disclosed to the taxpayer, then there would have been a meeting of the minds on this issue.

Furthermore, on May 1, 1982 the intent of the parties was irrelevant as to whether the requirements of Sec. 422A were met or not. The intent of the parties was not considered by Congress until a later date and included in an amendment to Sec. 422A after May 1, 1982.[12] Consequently, neither the Tax Court nor the Second Circuit

should have considered the intent of the parties in its determination of this case.

Lastly, the provisions of the Repurchase Agreement itself specifically exclude from the tax language of Par. 12 of the Repurchase Agreement valid, existing, incentive stock options.

Paragraph 5.7 of the Repurchase Agreement specifically states: (Stip. Ex. 42, pp. 15-16)

> 5.7. Benefit Plans
>
> Company does not have, maintain or offer and is not a party to...(ii) any employee stock option or incentive stock option plan within the meaning of the Internal Revenue Code, other than pursuant to the terms of the Option Agreement...

In short, the language of the foregoing specifically excluded Par. 12 from being applied to this case because Epson recognized the Option Agreement as an incentive stock option plan, and the Second Circuit erred in not so holding, even though the provisions of 5.7 were brought to the Appellate Court's attention during oral argument. The plain, unequivocal language of Par. 5.7 clearly recognizes the Option Agreement to be an incentive stock option plan within the meaning of the Internal Revenue Code.

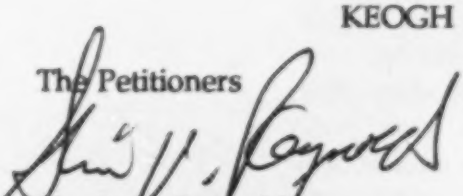
## CONCLUSION

For the foregoing reasons, it is respectfully submitted that the matter should be reversed and remanded to the Tax Court.

Respectfully submitted,

PATRICK J. KEOGH and JUDITH KEOGH

The Petitioners

By: 

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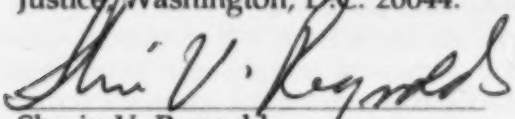
## CERTIFICATE OF SERVICE

I HEREBY CERTIFY that on the 17th day of October, 1995 copies of the foregoing and attached PETITION FOR A WRIT OF CERTIORARI were served on counsel for the United States by depositing copies thereof, postage prepaid, in the United States mail, addressed to the Solicitor General of the United States, Department of Justice, Washington, D.C. 20044.



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## ENDNOTES

1. The Tax Court determined in its Opinion below that none of the penalties assessed by respondent were due or owing.

2. In the Tax Court below on brief (pp. 4), respondent expressly conceded error in the proposed additions to tax under Section 6661 for the years 1985 and 1986 in the amounts of $186,475.00 and $2,348.00, respectively.

3. The Tax Court was obligated to look at all of the evidence of record including jointly presented evidence, as well as the evidence presented by the respondent, not just the evidence presented by the taxpayer. The Tax Court erred in not doing so.

4. It is uncontradicted since Keogh was never cross-examined at trial and Respondent presented no witness or other evidence to demonstrate that Keogh's testimony was untrue.

5. BY MS. VINOCUR:
   Q. Was there any discussion with Mr. Keogh or his attorney regarding the option exercise price?
   A. Again, I don't recall specifically, generally, I would say the likelihood is high because that was the essence of discussions with each of them. I'm sorry. That was a portion of the discussions with each of them.
   Q. The option exercise price?
   A. Yes.

6. See "Proposed treasury regulations" 1.422A-2(e)(2)(ii) which the Fifth Circuit in Hope v. United States 803 F.2d 816 (C.A. 5th, 1986) held (p. 819) invalid on the

grounds "the agency regulation may not amend the statute" but "must implement the (congressional) mandate in some reasonable manner."

7. A party to litigation who calls an expert witness to testify in his behalf "must cause that witness to prepare a written report." Tax Court Rule 143(f) requires a party to do something the party has no legal power or authority to do.

8. See Tr. pp. 6-7.

9. At trial (Tr. p. 5) the Tax Court in fact stated: ..."our rule contemplates that the expert report will be — will substitute for direct expert testimony. That's one of the purposes of the rule. Go ahead. (Emphasis added.)

10.

> THE COURT: Not if it was a one page summary. As I told you, Mr. Reynolds, in conference, our rule contemplates that the expert report will be – will substitute for direct testimony. That's one of the purposes of the rule. Go ahead.
>
> MR. REYNOLDS: Your Honor, the rule for the Tax Court is, as you're aware, among the interrogatories and among the discovery procedure of the Court. I did not receive any notice from the Clerk of the Court or from anyone else in the Court advising me that the expert testimony, the expert witness' report had to be exchanged within fifteen days prior to trial.
>
> Normally in Federal Court, in the Federal District Court, it is the actual testimony of the expert witness that counts and the report itself is really not evidence, although it may be sometimes received into evidence; it is actually the opinion of the witness that counts.
>
> I was confused as far as that was concerned, Your Honor, and I apologize to the Court for it, but justice I feel would be served

> if the Court would accept the testimony and the report of Mr. Malinowski as the Petitioner's expert witness in this case.
>
> Today is Friday and the report was completed and hand-delivered to Ms. Vinocur this past Tuesday; a copy was also filed with the Clerk and delivered to the Court. The Respondent has had from Tuesday until today, Your Honor, to contact Mr. Malinowski or to do any other thing that it wished to do with regard to the expert's report, and is probably not prejudiced by the fact that it only received the report on Tuesday.
>
> So, Your Honor, for those reasons, namely lack of prejudice to the Respondent, since they had several days to review the report and interview or talk to Mr. Malinowski, who is right here in Hartford. Also, Your Honor, because in the interest of justice one of the questions presented in this case is the fair market value of certain shares of stock and for that reason I would urge the Court (1) to accept the report of the Petitioner's expert and (2) to also receive into evidence his testimony here this morning.
>
> THE COURT: Mr. Reynolds, it's the Court's view that justice requires observance of the rules... (Emphasis added.)

It is interesting to note exactly what the Tax Court said at trial about Rule 143(f). (Tr. pp. 5) "As I told you, Mr. Reynolds, in conference, our rule contemplates that the expert report will be – will substitute for direct testimony. That's one of the purposes of the rule." (Emphasis added.)

It is respectfully submitted that when the Supreme Court of the United States promulgates rules of evidence, and these rules are adopted by a Court as the Tax Court did, no substitutions should be allowed.

11. Specifically, with regard to the instant case Respondent in the Supplemental Appendix (pp. 19-76) filed with

the United States Court of Appeals in the Second Circuit the written appraisal report of the Government's expert witness. It is not under oath. It is not even signed by the individual who prepared it. The written report is signed BPO Seidman, which is the name of the company or a corporation.

12. See Committee Reports on P.L. 100-647. (Technical and Miscellaneous Revenue Act of 1988). This 1988 amendment provides that an option agreement will not be treated as an incentive stock option if the terms of the agreement so provide. However, this amendment to Sec. 422A occurred long after May 1, 1982, and long after 1985, the taxable year in question in this case.

## APPENDIX A

### Title 26 U.S.C. §421. GENERAL RULES

(a) **Effect of qualifying transfer**. If a share of stock is transferred to an individual in a transfer in respect of which the requirements of section 422(a), 422A(a), 423(a), or 424(a) are met –

(1) except as provided in section 422(c)(1), no income shall result at the time of the transfer of such share to the individual upon his exercise of the option with respect to such share;

(2) no deduction under section 162 (relating to trade or business expenses) shall be allowable at any time to the employer corporation, a parent or subsidiary corporation of such corporation, or a corporation issuing or assuming a stock option in a transaction to which section 425(a) applies, with respect to the share so transferred; and

(3) no amount other than the price paid under the option shall be considered as received by an employee of such corporations for the share so transferred.

### Title 26 U.S.C. §422A. INCENTIVE STOCK OPTIONS

(a) In General - Section 421(a) shall apply with respect to the transfer of a share of stock to an individual pursuant to his exercise of an incentive stock option if -

(1) no disposition of such share is made by him within 2 years from the date of the granting of the option nor within 2 year after the transfer of such share to him, and

(2) at all times during the period beginning on the date of the granting of the option and ending on the day 3 months before the date of such exercise, such individual was an employee of either the corporation granting such option, a parent or subsidiary corporation of such; or assuming a stock option in a transaction to which section 425(a) applies.

**Title 26 U.S.C. §7441. STATUS**

There is hereby established under article I of the Constitution of the United States, a court of record to be known as the United States Tax Court. The members of the Tax Court shall be the chief judge and the judges of the Tax Court.

**Title 26 U.S.C. §7453. RULES OF PRACTICE, PROCEDURE AND EVIDENCE**

Except in the case of proceedings conducted under section 7463, the proceedings of the Tax Court and its division shall be conducted in accordance with such rules of practice and procedure (other than rules of evidence) as the Tax Court may prescribe and in accordance with the rules of evidence applicable in trials without jury in the United States District Court of the District of Columbia.

**Rule 1. Scope of Rules and construction**

(a) **Scope.** These Rules govern the practice and procedure in all cases and proceedings in the United States Tax Court. Where in any instance there is no applicable rule of procedure, the Court or the Judge before whom the matter is pending may prescribe the procedure, giving particular weight to the Federal Rules of Civil Procedure to the extent that they are suitably adaptable to govern the matter at hand.

(b) **Construction.** These Rules shall be construed to secure the just, speedy, and inexpensive determination of every case.

**Rule 143. Evidence**

(a) **General.** Trials before the Court will be conducted in accordance with the rules of evidence applicable in trials without a jury in the United States District Court for the District of Columbia. See Code Section 7453. To the extent applicable to such trials, those rules include the rules of evidence in the Federal Rules of Civil Procedure and any rules of evidence generally applicable in the Federal Courts (including the United States District Court for the District of Columbia). Evidence which is relevant only to the issue of a party's entitlement to reasonable litigation costs shall not be introduced during the trial of the case. As to claims for reasonable litigation costs, see Rules 231 and 232.

(f) **Expert Witness Reports.** Unless otherwise permitted by the Court upon timely request, any party who calls an expert witness shall cause that witness to prepare a written report for submission to the Court and to the opposing party. The report shall set forth the qualifications of the expert witness and shall state his opinion and the facts or data on which that opinion is based. The report shall set forth in detail the reasons for the conclusion, and it will be marked as an exhibit, identified by the witness, and received in evidence as the direct testimony of the expert witness, unless the Court determines that he is not qualified as an expert. Additional direct testimony with respect to the report may be allowed to clarify or emphasize matters in, to cover matters arising after the preparation of the report, or otherwise at the discretion of the Court. If not furnished earlier, each party who calls any expert witness shall furnish to each other party, and shall submit to the Court, not later than 15 days prior to the call of the trial calendar on which the case shall appear, a copy of all expert witness reports prepared pursuant to this subparagraph. An expert witness testimony will be excluded altogether for failure to comply with the provisions of this paragraph, unless the failure is shown to be due to good cause and unless the failure does not unduly prejudice the opposing party, such as by significantly impairing his ability to cross-examine the expert witness or by denying the opposing party the reasonable opportunity to obtain evidence in rebuttal to the expert witness' testimony.

**Title 28 U.S.C. §88. District of Columbia**

The District Court of Columbia constitutes one judicial district.

Court shall be held at Washington.

(June 25, 1948, c. 646, 62 Stat. 875.)

**Title 28 U.S.C. §2071. Rule-making power generally**

(a) The Supreme Court and all courts established by Act of Congress may from time to time prescribe rules for the conduct of their business. Such rules shall be consistent with Acts of Congress and rules of practice and procedure prescribed under section 2072 of this title.

Title 28 U.S.C. §2072. **Rules of procedure and evidence; power to prescribe**

(a) The Supreme Court shall have the power to prescribe general rules of practice and procedure and rules of evidence for cases in the United States district courts (including proceedings before magistrates thereof) and courts of appeals.

(b) Such rules shall not abridge, enlarge or modify any substantive right. All laws in conflict with such rules shall be of no further force or effect after such rules have taken effect.

Title 28 U.S.C. FEDERAL RULES OF CIVIL PROCEDURE

**Rule 43. Taking of Testimony**

(a) **Form.** In all trials the testimony of witnesses shall be taken orally in open court, unless otherwise provided by an Act of Congress or by these rules, the Federal Rules of Evidence, or other rules adopted by the Supreme Court.

Title 28 U.S.C. FEDERAL RULES OF EVIDENCE

**Rule 611. Mode and Order of Interrogation and Presentation**

(a) **Control by court.** The Court shall exercise reasonable control over the mode and order of interrogating witnesses and presenting evidence so as to (1) make the interrogation and presentation effective for the ascertainment of the truth, (2) avoid needless consumption of time, and (3) protect witnesses from harassment or undue embarrassment.

(b) **Scope of cross-examination.** Cross-examination should be limited to the subject matter of the direct examination and matters affecting the credibility of the witness. The court may, in the exercise of discretion, permit inquiry into additional matters as if on direction examination.

(c) **Leading questions.** Leading questions should not be used on the direct examination of a witness except as may be necessary to develop the witness' testimony. Ordinarily leading questions should be permitted on cross-examination. When a party

calls a hostile witness, an adverse party, or a witness identified with an adverse party, interrogation may be by leading questions.

(As amended Mar. 2, 1987, eff. Oct. 1, 1987.)

**Rule 614. Calling and Interrogation of Witnesses by the Court**

**(a) Calling by court**

The court may, on its own motion or at the suggestion of a party, call witnesses, and all parties are entitled to cross-examine witnesses thus called.

## ARTICLE VII. OPINIONS AND EXPERT TESTIMONY

**Rule 701. Opinion Testimony by Lay Witnesses**

If the witness is not testifying as an expert, the witness' testimony in the form of opinions or inferences is limited to those opinions or inferences which are (a) rationally based on the perception of the witness and (b) helpful to a clear understanding of the witness' testimony or the determination of a fact in issue.

(As amended Mar. 2, 1987, eff. Oct. 1, 1987.)

**Rule 702. Testimony by Experts**

If scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training, or education may testify thereto in the form of an opinion or otherwise.

**Rule 703. Basis of Opinion Testimony by Experts**

The fact or data in the particular case upon which an expert bases an opinion or inference may be those perceived by or made known to the expert at or before the hearing. If of a type reasonably relied upon by experts in the particular field in forming opinions or inferences upon the subject, the facts or data need not be admissible in evidence.

**Rule 704. Opinion on Ultimate Issue**

(a) Except as provided in subdivision (b), testimony in the form of an opinion or inference otherwise admissible is not objectionable because it embraces an ultimate issue to be decided by the trier of fact.

**Rule 705. Disclosure of Facts or Data Underlying Expert Opinion**

The expert may testify in terms of opinion or inference and give reasons therefor without first testifying to the underlying facts or data, unless the court requires otherwise. The expert may in any event be required to disclose the underlying facts or data on cross-examination.

(As amended Mar. 2, 1987, eff. Oct. 1, 1987; Apr. 22, 1993, eff. Dec. 1, 1993.)

UNITED STATES COURT OF APPEALS
FOR THE
SECOND CIRCUIT

At the stated Term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse, Foley Square, in the City of New York, on the 20th day of July, one thousand nine hundred and ninety-five.

Present: Hon. Roger J. Miner,
Hon. Fred I. Parker, Circuit Judges
Hon. Harold Baer, Jr.,
District Judge.

PATRICK J. KEOGH and JUDITH KEOGH,

Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

UNITED STATES COURT OF APPEALS
FILED JULY 20, 1995
GEORGE LANGE III, CLERK

SECOND CIRCUIT

Docket No. 92-4133

A petition for the rehearing having been filed herein by petitioners-appellants Patrick J. Keogh and Judith Keogh,

Upon consideration by the panel thereof, it is

Ordered that said petition be and it hereby is DENIED.

FOR THE COURT
GEORGE LANGE III, CLERK
By: s/_____
Beth J. Meador Date
Administrative Attorney

* The Hon. Harold Baer, Jr. of the United States District Court for the Southern District of New York, sitting by designation.

UNITED STATES COURT OF APPEALS
SECOND CIRCUIT

PATRICK J. KEOGH and JUDITH KEOGH,

Petitioners-Appellants,

vs. Docket No. 92-4133

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

## PETITION FOR REHEARING

COMES NOW the Petitioners-Appellants in the above-captioned cause of action, Patrick J. Keogh and Judith Keogh, by their attorney, and in accordance with Rule 40 of the Federal Rules of Appellate Procedure move this Honorable Court for a Rehearing of the decision entered on March 30, 1995.

The taxpayers appealed to this Court because the Tax Court below held that the taxpayers presented "no evidence" as to the fair market value of the stock at the time the option was granted.

By affirming the decision of the Tax Court below this Court is, in effect, holding that a valid, duly executed bilateral contract, in writing, negotiated and executed at arm's length, setting forth a price or value of $5.00 per share and received into evidence by the Tax Court below constitutes absolutely no evidence whatsoever as to the fair market value of that stock, not even the proverbial scintilla of evidence. There seems to be something inherently erroneous about such a holding.

Secondly, Sec. 422A(b)(4) holds that the option price of an incentive stock option share be not less than the fair market value of the stock at the time the option is granted. The taxpayers appealed to this Court and cited as grounds for error the fact that the Tax Court never made a determination of the fair market value of the stock at the time the option was granted The Tax Court held that it was not required in this case to determine the precise value of the shares of stock on May 1, 1982. Not only did the Tax Court not determine the precise value, it did not even determine a "ball park" value. It made absolutely no determination of value.

On brief the taxpayers argued the Tax Court erred in its holding. In its decision this Court did not address this issue at all. Thus, in affirming the Tax Court's decision below this Court is, in effect, holding that even though the statute enacted by Congress, Sec. 422A(b)(4) states the incentive stock option shares be not less than fair market value, there is absolutely no necessity for the Tax Court to determine fair market value so that the price paid of $5.00 per share could be compared to the determined fair market value to see whether it complied with the statute or not. Again, there is something inherently wrong with this Court's decision and that of the Tax Court below.

## THE TAIL WAGS THE DOG

In Sec. 422A of the Code Congress has stated, that if the requirements of Sec. 422A are met, then it meets the definition of an incentive stock option and is to be accorded favorable capital gains treatment instead of ordinary income tax treatment. This is an example of a dog wagging its tail.

In its decision this Court (and the Tax Court below) leaps to a section of the Option Agreement drafted by one of the parties to conform to its own self interest, and concluded that the Option Agreement couldn't be an incentive stock option because of the language in the Option Agreement regarding taxes. In short, the latter form of analysis is an example of the tail wagging the dog. The problem with the latter form of analysis is that it does not meet the requirements of Sec. 422A and is not the analysis Congress had in mind. Congress stated that if an agreement meets the requirements of Sec. 422(A)(b)(1), it is an incentive stock option. Congress did not say look for the intent of the parties and how one side of the agreement characterized the tax treatment.

## CLEARLY ERRONEOUS

The taxpayer argued extensively in its Reply Brief that the Tax Court erred and that it's Opinion was "clearly erroneous" in that the Tax Court failed to make a determination of the fair market value of the Computronics stock at the time the option was granted, May 1, 1982. In its decision this Court adopted the "clearly erroneous" standard of review citing the case of Victorson v. CIR, 326 F.2d 264, 267 (2d Cir. 1964). The irony of the case cited by this Court is that it is a tax case, reviewing a decision of the Tax Court, in which the question of fair market value of stock was at issue, and there the Tax Court in fact made a determination of the fair market value of stock at issue, and there the Tax Court in fact determined the fair market

value of the stock to be fifty cents a share, whereas in the instant case no fair market value was determined. How can this Court cite Victorson, supra, for the "clearly erroneous" standard of review and hold the Tax Court was not clearly erroneous in either case, whether it made a determination of fair market value, as in Victorson, supra, or not as in the case at bar? How can the Tax Court be right in both situations?

THIS COURT "OVERLOOKED OR MISAPPREHENDED" TAXPAYERS' ARGUMENTS WITH REGARD TO RULE 143(f)

In both the taxpayers' initial Brief and Reply Brief the taxpayers made an extensive argument that Tax Court Rule 143(f) was in conflict with itself and with the rules of evidence and procedure promulgated by the Supreme Court. Normally, if a United States District Court decides a case which is directly in conflict with the law as determined by the Supreme Court, a Court of Appeals generally wastes no time in upholding the Supreme Court and the law of the land.

Yet in the instant case the taxpayer argued vigorously that the Tax Court in promulgating Rule 143(f) had enacted a rule which is inconsistent with its own rules as well as those of the Supreme Court. However, with regard to such argument this Court has elected to overlook or misapprehend a Tax Court ruling in this case concerning a rule of evidence directly in conflict with a rule promulgated by the Supreme Court.

Basically, what the Tax Court did was, in effect, to dismiss the taxpayers' case for what in the federal court would be a discovery violation. However, it would be error for a District Court to do this in this circuit. As the Court in Spence v. Maryland Gas Co., 803 F.Supp. 649 (W.D.N.Y. 1992) held, dismissal because of a discovery violation is a drastic penalty which should be imposed only in extreme cases. This District Court went on to hold (p.661):

> The extreme circumstances contemplated by the Second Circuit require that the "sanction of dismissal should not be imposed under Rule 37 unless the failure to comply with a pretrial production order is due to 'willfulness, bad faith, or any fault' of the party." Jones v. Niagara Frontier Transp. Auth., 836 F.2d 731, 734 (2d Cir. 1987) quoting Salahuddin, 782 F.2d at 1132.

In the case at bar there was no evidence whatever of willfulness, bad faith or any fault on the part of the taxpayers. On the contrary, taxpayers were following the Court's own rule which was the federal rules of evidence and procedure as it pertained to evidence in 1990, the time of the trial. If this (dismissal or the equivalent of striking the entire complaint) couldn't happen to the taxpayer in a District Court under its jurisdiction why should this Court allow it to happen in the United States Tax Court?

In the relatively recent case of Kotes v. Superfresh Food Markets, Inc., 157 F.R.D. 18 (E.D. Pa. 1994) the federal district court interpreted the 1993 amendments to the Federal Rules of Civil Procedure and particularly Rule 26(a)(1) which now requires parties to disclose all potential witnesses to their adversaries without awaiting a discovery request, and Rule 37(c)(1) which now states that witnesses not timely disclosed may be excluded from testifying.

In Kotes, supra, both parties had failed to identify certain witnesses and the Court held that inasmuch as there was no showing of bad faith and because a revised trial date would allow the parties to cure any prejudice suffered from the nondisclosure, the testimony of the nondisclosed witness would not be excluded.

It is respectfully submitted that there was no willfulness or bad faith on the part of the taxpayers in 1990 when this occurred. Taxpayers were following the federal rules of evidence which the Tax Court had adopted. Since the law in the Second Circuit requires bad faith or willfulness, and there was none on taxpayers' part, the same law should have applied to the taxpayers in the Tax Court in 1990.

## SUMMARY

The taxpayers appealed the Tax Court's opinion and decision to this Court because the Tax Court held taxpayers presented "no evidence" as to the fair market value of the stock at the time of the option. In affirming the Tax Court's opinion and decision of "no evidence" this Court is, in effect, holding that a Stipulation of Facts filed with the Tax Court is "no evidence" of anything; that a valid contract setting forth a price negotiated at arm's length (as conceded by the Government) is "no evidence" of the fair market value of the stock; that 11 other sales on the same day at the same price by Epson to the 11 other executives constitutes "no evidence" of fair market value. Such holding would be inherently erroneous. Obviously they all constitute some evidence of fair market value, and it cannot be said they constitute "no evidence."

Second, the Tax Court erred in not determining any fair market value and this Court should so hold. The option price of $5.00 per share has to be compared to a determined fair market value in order to hold whether Sec. 422A(b)(4) has been met or not. Otherwise we enter the realm of the ludicrous.

Lastly, the Tax Court erred in not allowing taxpayers' expert witness to testify, and for the many reasons already set forth, including the law as set forth by this Court in Spence v. Maryland Gas Co., supra; Jones, supra; Salahuddin, supra; and, the Kotes Case, supra.

## CONCLUSION

For the foregoing reasons and the reasons stated in the taxpayers' initial brief and reply brief the case should be reversed and remanded to the Tax Court.

Dated this 12th day of April, 1995.

The Petitioner-Appellants
Patrick J. Keogh and Judith Keogh

By: s/ Sherin V. Reynolds
Sherin V. Reynolds
2 Royal Palm Way
P.O. Box 987
Boca Raton, FL 33429
Tel. (407) 382-9010
THEIR ATTORNEY

## CERTIFICATE OF SERVICE

I HEREBY CERTIFY that on April 12, 1995 a true copy of the attached Petition for Reconsideration was served on counsel for the Respondent-Appellee by depositing a copy thereof, postage prepaid, in the United States mail addressed to Kenneth L. Greene, Appellate Section, Tax Division, Dept. of Justice, P.O. Box 502, Washington, D.C. 20044.

s/ Sherin V. Reynolds
Sherin V. Reynolds

UNITED STATES COURT OF APPEALS
SECOND CIRCUIT

PATRICK J. KEOGH AND
JUDITH KEOGH,

Petitioners-Appellants,

vs. Docket No. 92-4133

COMMISSIONER OF INTERNAL REVENUE

Respondent-Appellee.

ORDER

Petitioner-Appellant filed a Petition for Rehearing requesting this Court to rehear its decision entered on March 30, 1995 in this case. After due consideration and deliberations it is hereby,

ORDERED, that the Petition for Rehearing be ___Granted/___Denied.

Dated this _____ day of _____, 1995.

_____
By the Court

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

At the stated Term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse, Foley Square, in the City of New York, on the 30th day of March, one thousand nine hundred and ninety-five.

Present: Hon. Roger J. Miner,
Hon. Fred I. Parker, Circuit Judges
Hon. Harold Baer, Jr.,* District Judge.

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PATRICK J. KEOGH and JUDITH KEOGH,
Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

UNITED STATES COURT OF APPEALS
FILED MARCH 30, 1995
GEORGE LANGE III, CLERK
SECOND CIRCUIT

ORDER 92-4133

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UPON CONSIDERATION of this appeal from a decision of the United State Tax Court, it is hereby

ORDERED, ADJUDGED, AND DECREED that the decision be and it is hereby AFFIRMED.

Petitioners-appellants Patrick and Judith Keogh appeal from a decision entered on May 5, 1992 in the United States Tax Court (Whitaker, J.), following a bench trial, the tax court having found that the stock options granted to petitioner Patrick Keogh (hereinafter referred to as "petitioner") by his employer did not qualify as "incentive stock options" within the meaning of 26 U.S.C. § 422A, and therefore that the proceeds of the sale of the stock acquired by exercising the options constituted ordinary income rather than long-term capital gain.

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*The Hon. Harold Baer, Jr. of the United State District Court for the Southern District of New York, sitting by designation.

This case involved the tax treatment of a stock option that petitioner's former employer, Computronics Distributing, Inc., formerly known as Vitex Distributing, Inc. ("Computronics") granted him in May of 1982. Computronics was one of twelve distributors organized to distribute the products of Epson America, Inc. ("Epson"). On May 1, 1982, Epson formed Computronics and capitalized the company with $375,000 in exchange for 37,500 shares of Computronics common stock. Also on that date, petitioner entered into an employment agreement with Computronics under which he became the company's president and chief executive officer. As part of his compensation package, petitioner entered into a stock option agreement under which Computronics offered petitioner options to purchase authorized but unissued shares of Computronics common stock for $5.00 per share beginning in August of 1984. On May 17, 1984, the parties modified the Option Agreement to allow petitioner to exercise his option to purchase 6618 shares on or after May 17, 1984 but before February 1, 1985. On May 30, 1984, petitioner exercised his option and acquired 6,618 shares of Computronics common stock at $5.00 per share.

On May 1, 1985, petitioner, Computronics, and Epson entered into a repurchase agreement providing for the repurchase of all of petitioner's Computronics stock. Epson sent petitioner a check for $1,414,365 on June 27, 1985, and then paid the balance of $665,830 to petitioner on August 27, 1985. On his 1985 income tax return, petitioner reported the gain from his sale of Computronics stock as long-term capital gain. Respondent, in a notice of deficiency dated March 29, 1989, determined that the disposition of stock resulted in ordinary income rather than capital gain for petitioner.

Petitioner then filed a petition in tax court for a redetermination of the proposed deficiency in income taxes, penalties and interest. After the parties resolved certain issues not relevant to this appeal, the tax court scheduled trial to begin on March 20, 1990. At a pre-trial conference held on March 6, 1990, the parties discussed the petitioner's plan to present an expert witness at trial. The tax court instructed petitioner's counsel to submit an expert witness report by March 7, 1990. On March 7, petitioner submitted to the respondent-commissioner a one-page letter from petitioner's proposed expert that did not contain the expert's qualifications or conclusions. Then, on March 16, petitioner informed respondent that he would not be relying on the testimony of the original expert but rather that he would put forth another expert. The trial was postponed until March 23. On March 20, petitioner delivered a copy of a report prepared by his expert witness to respondent. The trial began on March 23, but petitioner's expert was not permitted to

testify because of petitioner's failure to comply with Tax Court Rule 143(f).

Following the trial, the tax court determined that the stock option did not qualify as an incentive stock option because there was no evidence that the $5.00 per share price was the fair market value on the date the option was granted as required under section 422A(b)(4). Because the option was not an incentive stock option, the gain on the sale of the stocks obtained pursuant to the option was considered ordinary income rather than long-term capital gain. The court also found that petitioner was not subject to negligence additions to tax.

Petitioner contends that the tax court erred in finding that the $5.00 per share price was not the fair market value of the shares at the time the option was granted. Generally, if the requirements for incentive stock option treatment are met, any gain on the sale of shares obtained pursuant to the option are treated as long-term capital gain. See 26 U.S.C. § 421(A). To achieve this special treatment, however, the Internal Revenue Code "imposes specific requirements with respect to the terms of the option." 3 Jacob Rabkin & Mark H. Johnson, Federal Income, Gift and Estate Taxation § 14.15 at 14-129 (1994). Section 422A(b) provides that "the term 'incentive stock option' means an option granted to an individual ... by the employer corporation or its parent or subsidiary corporation, to repurchase stock of any such corporations, but only if--... (4) the option price is not less than fair market value of the stock at the time such option is granted." We review the tax court's finding of fact for clear error. See Victorson v. CIR, 326 f.2d 264, 267 (2d Cir. 1964).

In this case, the Option Agreement provides ample evidence that the parties did not intend the stock option to be anything other than ordinary compensation. Paragraph 3.7 of the Option Agreement specifically provides that "[i]t is contemplated by the Company and by [petitioner] that any and all payments made by the Company to [petitioner] ... shall be deductible by the Company as ordinary and necessary business expenses for federal income tax and other tax purposes. [Petitioner] covenants ... that he will not make any claims or representations as to the income tax nature of any such payment." (emphasis added.) The company also had the right to deduct "all sums required for social security and withholding taxes and for any other federal, state or local tax." This language is clearly inconsistent with an incentive stock option. Accordingly, the tax court's finding is not clearly erroneous.

Petitioner also claims that the court failed to consider section 422A(c)(1), which states that if a transfer of stock pursuant to a stock option plan "would fail to qualify as an incentive stock option under subsection (b) because there was a failure in an attempt, made in good faith, to meet the requirements of subsection (b)(4), the requirement of subsection (b)(4) shall be considered to have been met." We are not persuaded. The fact that petitioner spoke with two of the other distributorship's presidents to determine if $5.00 was a "good price" does not suggest that petitioner was concerned with determining the fair market value. A good price is just as easily interpreted as a bargain. Moreover, there was no evidence that petitioner discussed the fair market value with the officers of Epson or Epson's attorney. Therefore, the tax court's finding is not clearly erroneous.

Petitioner claims that the tax court abused its discretion by refusing to allow his expert witness to testify. Tax Court Rule 143(f) requires any party who plans to call an expert witness to "cause that witness to prepare a written report for submission to the Court and to the opposing party." The report must include the qualifications of the witness as well as his opinion and the facts or data on which it is based. As it applied to this case, the rule required the expert's report to be submitted to the court and opposing counsel fifteen days before "the call of the trial calendar." Finally, Rule 143(f) states that the "expert witness' testimony will be excluded altogether for failure to comply with the provisions of [the rule]."

Here, trial was scheduled to begin on March 20, 1990. On March 6, at a pre-trial conference, the tax court specifically informed petitioner's counsel that his expert's report must be submitted to the court and opposing counsel by March 7. On March 7, petitioner failed to submit an appropriate report, submitting instead a one-page draft that did not comply with Rule 143(f). Then, on March 16, petitioner's counsel informed respondent that he would not be relying on that expert but, rather, that he would present another expert. Petitioner never informed the court of this fact and never requested a continuance in order to comply with the mandates of Rule 143(f). Finally, three days before trial was to begin, petitioner submitted his expert witness report to respondent.

On March 23, the trial court inquired as to why petitioner had not complied with Rule 143(f). Counsel claimed that he was not aware of the tax court rules and that the delay was caused by his first expert, who decided to cancel. The record indicates that petitioner was given ample opportunity to submit his expert's report

but failed to do so. Under the circumstances, we find that the tax court did not abuse its discretion in excluding the expert testimony.

s_____
HON. ROGER J. MINER

s_____
HON. FRED I. PARKER
Circuit Judges.

s_____
HON. HAROLD BAER, JR.
District Judge.

T.C. Memo. 1992-131

UNITED STATES TAX COURT

PATRICK J. KEOGH AND JUDITH KEOGH, Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 6970-89. Filed March 4, 1992

Held: Petitioner Patrick J. Keogh's stock option does not qualify under sec. 422A(b)(4); petitioners are not liable for the negligence additions or the sec. 6661 addition.

Sherin V. Reynolds, for petitioners.

Nancy M. Vinocur, for respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

WHITAKER, Judge: Respondent determined deficiencies in and additions to petitioners' Federal income tax for tax years ended December 31, 1985, and 1986 as follows:

| | | Additions to Tax | | |
|---|---|---|---|---|
| Tax Year Ended | Deficiency | Sec. 6653(a)(1)(A) | Sec. 6653(a)(1)(B) | Sec. 6661 |
| 12-31-85 | $745,899 | $37,295 | 50% of the interest due on $745,899 | $186,475 |
| 12-31-86 | $ 9,392 | $ 470 | 50% of the interest due on $ 9,392 | $ 2,348 |

1 For 1985 the sections are 6653(a)(1) and 6653(a)(2), respectively.

The principal issue before the Court is whether amounts received by petitioner Patrick J. Keogh upon the disposition of stock in 1985 are taxable as ordinary income pursuant to section 83[1] or whether transfer of the stock to petitioner Patrick J. Keogh was pursuant to the exercise of an incentive stock option under section 422A as a consequence of which petitioners could treat the gain on the disposition of stock as capital gain. The second issue is whether petitioners are subject to additions to tax pursuant to section 6653(a) for tax years ended December 31, 1985, and 1986. Respondent has conceded that petitioners are not subject to the addition to tax pursuant to section 6661 in either year.

This will be the second opinion which we have filed in this case. On March 13, 1990, in T.C. Memo. 1990-131, we denied petitioners' motion for summary judgment because it was quite clear that there were genuine issues of material fact which were in dispute. Our opinion in T.C. Memo. 1990-131 is incorporated herein by this reference, and we will repeat the facts only to the extent necessary for an understanding of this opinion.

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[1]Unless otherwise noted, all section references are to the Internal Revenue Code of 1954 in effect for the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

## FINDINGS OF FACT

Some of the facts in this case have been stipulated and are so found. The stipulation and attached exhibits are incorporated herein by this reference. At the time of filing the petition in this case petitioners were husband and wife, residing in Easton, Connecticut. Hereinafter all references to petitioner are to Patrick J. Keogh, since only he was involved in the stock transactions in issue in this case. The issue arises out of a stock option with respect to stock of the corporation, Computronics Distributing, Inc. (Computronics), formerly known as Vitex Distributors, Inc. (Vitex).

On May 1, 1982, Epson America, Inc. (epson) formed Vitex as one of 12 distributors for products of Epson. Each of the distributors was a separate corporation with distinct territories within the United States. On May 1, 1982, petitioner entered into an employment agreement with Vitex pursuant to which he became that corporation's president and chief executive officer. On the same day he also entered into an Option Agreement pursuant to which he was authorized to purchase unissued shares of common stock of Computronics on various dates commencing on August 1, 1984. Petitioner deposited with Computronics the sum of $25,000.00 as a payment for the options, to be credited toward the purchase price of shares of stock according to a specified schedule. The Option Agreement provided that the price of shares of stock purchased by petitioner pursuant to said agreement was to be $5 per share. Similar agreements were entered into by Computronics or Epson with other distributor presidents/CEO's at the same price of $5 per share.

On May 30, 1984, petitioner exercised his option to acquire 6,618 shares of common stock of Computronics. On April 30, 1985, the Option Agreement was amended in order to cancel or terminate the right of petitioner to acquire further shares of Computronics. On March 25, 1985, an officer of Epson advised petitioner in writing that Epson would repurchase his shares of stock of Computronics in order to facilitate restructuring of the 12 regional distribution companies. On or as of May 1, 1985, petitioner, Computronics, and Epson entered into a repurchase agreement providing for the repurchase of all of petitioner's Computronics stock. Petitioner received from Epson the sum of $1,414,365 by check dated June 27, 1985, and transferred to Epson all of his shares of stock in Computronics. On Petitioners' 1985 joint Federal income tax return, the gain on petitioner's shares of Computronics stock was reported as long-term capital gain. Respondent in the notice of deficiency

determined that the disposition of stock resulted in ordinary income, not capital gain, for petitioner.

Prior to filing petitioners' 1985 Federal income tax return, petitioner discussed with and obtained the advice of his attorney, Sherin Reynolds, the attorney who represented petitioners in these proceedings. He also discussed with and obtained advice from Kevin Byrne who was then with the national accounting firm of Coopers & Lybrand and presumably was a certified public accountant. Petitioner's tax return preparer, James Crozier, also advised petitioner. Mr. Crozier, among other degrees, has a master's degree in taxation from the University of New Haven in West Haven, Connecticut. Mr. Crozier testified that, prior to reaching the conclusion that the gain on the resale of the stock to Computronics should be treated for Federal income tax purposes as capital gain, he did research which included reviewing sections 421 and 422 as well as several of the tax services. Mr. Crozier believed that there was substantial authority for reporting the sale proceeds as capital gain.

## OPINION

Section 422A includes a number of requirements which must be met in order for an option issued thereunder to be recognized as an incentive stock option. Respondent argues that petitioner's option failed to meet the requirements of section 422A(b)(1), (2), (4), and (8). For simplicity, we discuss principally section 422A(b)(4).

Section 422A(b)(4) requires that the option price of incentive stock option shares be not less than the fair market value of the stock at the time the option is granted. Petitioners presented no evidence as to the value of the shares at that time. Respondent's expert valued the shares at $16.01.

However, we are not required in this case to determine the precise value of the shares of stock on May 1, 1982. It is quite clear on the facts before the Court that petitioner simply accepted the $5 price set forth in the option contract without any discussion or negotiation as to that price with Computronics or with Epson personnel The $5 purchase price appeared in all 12 of the distribution agreements. There is no evidence that the $5 per share price was intended to represent the fair market value of the stock. Both Epson and Computronics intended the option to be part of the compensation package and the documents were presented to petitioner substantially on a "take it or leave it" basis. Since there is no evidence that either petitioner, Computronics, or Epson intended that this $5 per share price should reflect the market value of the

shares of stock, we are required to hold for respondent on that issue. The stock option issued to petitioner does not qualify as an incentive stock option issued pursuant to section 422A(b), since there is no evidence that the $5 price reflects fair market value on the critical date.

The remaining issue is whether or not petitioners are subject to the negligence addition. In this connection, respondent's counsel argues that there was no plan and that neither petitioner's attorney nor his tax return preparer ever attempted to determine the value of the Computronics stock as of the appropriate date. It is not necessary in this case to determine whether or not there was in fact an option plan, although it is entirely possible that the option agreement itself, or the option agreements with each of the 12 distributors together, would constitute an option plan. With respect to negligence, by consulting with his attorney, his tax accountant, and his tax return preparer, petitioner did all that was reasonably required of a taxpayer. Perhaps those individuals were in fact negligent, but that does not affect petitioners. Accordingly, we hold for petitioners on the issue of the negligence addition and find that it is not appropriate in this case either as to the tax years ended December 31, 1985, or 1986.

Decision will be entered under Rule 155.

T.C. Memo. 1990-131

UNITED STATES TAX COURT

PATRICK J. KEOGH AND JUDITH KEOGH, Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 6970-89. Filed March 13, 1990

Held: Petitioners' motion for summary judgment will be denied.

Sherin V. Reynolds, for petitioners.

Nancy M. Vinocur, for respondent.

MEMORANDUM OPINION

WHITAKER, Judge: This case is before us on petitioners' motion for summary judgment, filed under Rule 121.[1] Respondent has filed a notice of objection to petitioners' motion for summary judgment. At the outset, we note that petitioners' motion for summary judgment actually constitutes a motion for partial summary judgment since there are other issues in this case which will remain unresolved even is said motion is granted. Nevertheless, a motion for partial summary judgment is appropriate under Rule 121(b).

In his notice of deficiency dated March 21, 1989, respondent determined the following deficiencies in and additions to petitioners' Federal income tax:

| Tax Year | Deficiency | Section 6653(a)(1) | Section 6653(a)(2) | Section 6661 |
|---|---|---|---|---|
| 1985 | $745,899 | $37,295 | * | $186,475 |
| 1986 | 9,392 | 470[2] | * | 2,348 |

* 50 percent of the interest due on the underpayment (deficiency) determined respectively for each year

The sole issue with respect to which petitioners seek summary adjudication in their favor is whether the transfer of certain stock to petitioner Patrick J. Keogh was pursuant to the exercise of an "incentive stock option" under section 422A, thereby entitling petitioners to treat gain on the subsequent disposition of the stock as capital gain.

At the time of filing the petition, petitioners resided in Easton, Connecticut. Hereinafter references to petitioner are to Patrick J.

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[1] Unless otherwise noted, all Rule references are to the Tax Court Rules of Practice and Procedure, and all section references are to the Internal Revenue Code of 1954, as amended and in effect for the years in issue.

[2] Section 6653(a)(1) and section 6653(a)(2) were redesignated as section 6653(a)(1)(A) and section 6653(a)(1)(B), respectively, by the Tax Reform Act of 1986, Pub. L. 99-514, sec. 1503(a), 100 Stat. 2742. Thus, respondent determined the negligence additions to petitioners' 1986 tax pursuant to those redesignated sections.

Keogh since only he was involved in the stock transactions in issue in this case.

Epson America, Inc. (Epson) formed Vitex Distributors, Inc. (Vitex) on May 1, 1982, by contributing $375,000 in exchange for 37,500 shares of stock.[3] Epson and Vitex entered into a Distributorship Agreement on that same day. Pursuant to said agreement Vitex became one of 12 distributors for Epson, and as such engaged in the marketing and sales of Epson products.

Petitioner entered into an Employment Agreement with Vitex on May 1, 1982, pursuant to which he became that corporation's president and chief executive officer. Petitioner also entered into an Option Agreement with Epson and Vitex on that same day. Pursuant to the Option Agreement Vitex, which subsequently changed its name to Computronics Distributing, Inc. (Computronics), offered petitioner options to purchase authorized by unissued shares of common stock of Computronics in accordance with the following schedule:

| | | |
|---|---|---|
| 1.1.1. | On or after August 1, 1984, but before February 1, 1985 | Up to 6,618 shares |
| 1.1.2. | On or after May 1, 1985, but before November 1, 1985 | Up to 9,453 additional shares |
| 1.1.3. | On or after May 1, 1986, but before November 1, 1986 | Up to 14,610 additional shares |

In the Option Agreement, Computronics acknowledged receipt from petitioner of $25,000 as an option payment to be credited toward the purchase price of shares of stock as follows: $5,000 toward the purchase price of stock purchased pursuant to paragraph 1.1.1., $10,000 toward the purchase price of stock purchased pursuant to paragraph 1.1.2., and $10,000 toward the purchase price of stock purchased pursuant to paragraph 1.1.3. The Option Agreement also provided that the price of shares of stock purchased by petitioner pursuant to said agreement was to be $5 per share.

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[3] Although the record is not entirely clear, the parties apparently agree that Epson received 37,500 shares of stock of Vitex (a.k.a. Computronics Distributing, Inc.) in exchange for a capital contribution of $10 per share.

With the written consent of all parties thereto, the Option Agreement was modified on May 17, 1984, to allow petitioner to exercise the first stage of options on or after may 17, 1984, but before February 1, 1985. Petitioner obtained 6,168 shares of common stock of Computronics sometime after modification of the Option Agreement.

On April 30, 1985, the Option Agreement was amended by and Amendment to Option Agreement. Pursuant to the Amendment to Option Agreement, petitioner waived his right to exercise any unexercised options to purchase or otherwise acquire shares of stock of Computronics, including but not limited to those options exercisable in accordance with the schedule set forth in paragraphs 1.1.2. and 1.1.3. of the Option Agreement. The Amendment to Option Agreement further provided that in the event of any subsequent increase in the number of issued and outstanding shares of common stock of Computronics petitioner would be deemed to have been granted additional options to acquire sufficient stock to maintain his 15-percent ownership of the total outstanding common stock of Computronics.

By letter dated March 25, 1985, Jack A. Whalen, vice-president of Epson, advised petitioner that Epson would repurchase his shares of stock of Computronics to facilitate restructuring of the 12 regional distribution corporations as sales branch offices of Epson. As required by paragraph 3.5.1 of the Option Agreement, Computronics and Epson gave petitioner advance notice in the prescribed manner on March 29, 1985, that all of his shares of stock of Computronics would be repurchased. On May 1, 1985, petitioner, Computronics, and Epson entered into a Repurchase Agreement providing for the repurchase of petitioner's shares of stock of Computronics and the termination of the Option Agreement.

Petitioner subsequently received a check in the amount of $1,414,365, which was drawn on Epson's account at Citibank (Delaware) Citicorp and dated June 27, 1985. On July 3, 1985, petitioner endorsed and assigned the 6,618 shares of stock of Computronics to Epson.

Petitioner reported the gain on the sale of his shares of stock of Computronics on Schedule D of petitioners' 1985 joint Federal income tax return as long-term capital gain. In his notice of deficiency, respondent determined that petitioner's disposition of the stock of Computronics resulted in ordinary income, not capital gain.

Under Rule 121(b), summary judgment is appropriate "if the pleadings, answers to interrogatories, depositions, admissions, and any other acceptable materials, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that a decision may be rendered as a matter of law." See Naftel v. Commissioner, 85 T.C. 527, 529 (1985); Jacklin v. Commissioner, 79 T.C. 340, 344 (1982); Espinoza v. Commissioner, 78 T.C. 412, 416 (1982). The moving party bears the burden of proving that no genuine issue as to any material fact exists, and that he is entitled to judgment on the substantive issues as a matter of law. Naftel v. Commissioner, supra; Espinoza v. Commissioner, supra. In deciding whether to grant summary judgment, we view the factual material and inferences drawn therefrom in the light most favorable to the opposing party. Naftel v. Commissioner, supra; Espinoza v. Commissioner, supra. However, the party opposing summary judgment may not simply rest upon the mere allegations or denials of his pleadings; his response, by affidavit or otherwise, must set forth specific facts showing the existence of a genuine issue for trial. Rule 121(d).

Section 421(a) provides that the transfer of stock to an individual pursuant to the exercise of an option meeting the requirements of Section 422A shall not result in income to the transferee, and any gain upon disposition of such stock will be capital gain. Petitioner argues that the undisputed facts of this case demonstrate that the transfer to him of 6,618 shares of stock of Computronics was pursuant to the exercise of an option meeting the requirements of section 422A. Respondent, on the other hand, argues that there are genuine issues of material fact which preclude summary judgment on the issue of whether the options granted to petitioner met all of the requirements of section 422A.

As defined in section 422A(b), the term "incentive stock option" means an option granted to an individual for any reason connected with his employment by a corporation, if granted by the employer corporation or its parent or subsidiary corporation, to purchase stock of any such corporations, but only if the following requirements are satisfied:

> (1) the option is granted pursuant to a plan which includes the aggregate number of shares which may be issued under options and the employees (or class of employees) eligible to receive options, and which is approved by the stockholders of the granting corporation within 12 months before of after the date such plan is adopted;

(2) such option is granted within 10 years from the date such plan is adopted, or the date such plan is approved by the stockholders, whichever is earlier;

(3) such option by its terms is not exercisable after the expiration of 10 years from the date such option is granted;

(4) the option price is not less than fair market value of the stock at the time such option is granted;

(5) such option by its own terms is not transferable by such individual otherwise than by will or the laws of descent and distribution, and is exercisable, during his lifetime, only by him;

(6) such individual, at the time the option is granted, does not own stock possessing more than 10 percent of the total combined voting power of all classes of stock of the employer corporation or of its parent or subsidiary corporation;

(7) such option by its terms is not exercisable while there is outstanding (within the meaning of subsection (c)(7)) any incentive stock option which was granted, before the granting of such option, to such individual to purchase stock in his employer corporation or in a corporation which (at the time of the granting of such option) is a parent or subsidiary corporation of the employer corporation, or in a predecessor corporation of any of such corporations; and

(8) in the case of an option granted after December 31, 1980, under the terms of the plan the aggregate fair market value (determined as of the time the option is granted) of the stock for which any employee may be granted incentive stock options in any calendar year (under all such plans of his employer corporation and its parent and subsidiary corporation) shall not exceed $100,000 plus any unused limit carryover to such year.

Section 422A(b)(1) through (8).[4]

In opposing petitioners' motion for summary judgment, respondent asserts that the requirements set forth in section 422A(b)(1), (2), (4), and (8) were not satisfied. Thus, we must decide whether a genuine issue of material fact exists with respect to any of those requirements and, if not, whether petitioners are otherwise entitled to judgment on the incentive stock option issue as a matter of law.

Incentive Stock Option Plan

Petitioner asserts that the Option Agreement constituted a plan sufficient to satisfy the requirement of section 422A(b)(1). Specifically, petitioner asserts that both the aggregate number of shares which could be issued under options and the employees eligible to receive options (i.e., petitioner) were set forth in the Option Agreement. Petitioner further asserts that by executing the Option Agreement the stockholders of Computronics (i.e., Epson, the parent corporation of Computronics) approved the incentive stock option plan set forth in said agreement within the prescribed period of time.

To the contrary, respondent asserts that the parties to the Option Agreement never intended to grant petitioner incentive stock options and, therefore, that said agreement could not possibly constitute an incentive stock option plan. Respondent further alleges that stockholders neither adopted nor approved an incentive stock option plan, separate and apart from the Option Agreement.

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[4] The Tax Reform Act of 1986, Pub. L. 99-514, sec. 321(a), 100 Stat. 2220, amended section 422A(b)(6) through (8). Section 422A(b) was also amended by the Technical and Miscellaneous Revenue Act of 1988, Pub. L. 100-647, sec. 1003(d), 102 Stat. 3384-3385. however, petitioner apparently overlooked the fact that those amendments only apply to options granted after December 31, 1986. See Tax Reform Act of 1986, Pub. L. 99-514, dec. 321(c), 100 Stat. 2220; Technical and Miscellaneous Revenue Act of 1988, Pub. L. 100-647, sec. 1019(a), 102 Stat. 3593. Thus, petitioner advances certain arguments regarding incentive stock options which are premised on requirements not applicable with respect to the options granted to him. Presumably, petitioner fails for that same reason to advance any arguments regarding the requirements of section 422A(b)(7) and (8).

Respondent's allegations, if proved, would demonstrate that the Option Agreement failed to satisfy the requirements if section 422A(b)(1), and that no other incentive stock option plan satisfying those requirements existed. Thus, there remain genuine issues of material fact regarding whether the 6,618 shares of stock of Computronics were transferred to petitioner pursuant to a properly approved incentive stock option plan.[5]

With respect to the inquiry respondent plans to make into the intentions of the parties to the Option Agreement, petitioner asserts that "Whether the corporate officers did or did not intend the Option Agreement to qualify as an incentive stock option is irrelevant." Petitioner also asserts that "the Option Agreement speaks for itself," and that the parol evidence rule prevents respondent from going beyond the Option Agreement to determine the intent of the parties. We disagree.

The intent of the parties to the Option Agreement is relevant to our decision regarding the tax consequences of said agreement. Moreover, we may consider extrinsic evidence to determine the intent of the parties to the Option Agreement regardless of whether said agreement is ambiguous or unambiguous. If the Option Agreement is found to be ambiguous, we will be permitted to go beyond said agreement to determine the parties' intent. Smith v. Commissioner, 82. T.C. 705, 713-716 (1984). If the Option Agreement is found to be unambiguous, we will be permitted under the "third-party to the instrument rule" to go beyond said agreement to determine the parties' intent. That rule states that because respondent is an unrelated third party (i.e., not a party to the Option Agreement), neither petitioner nor respondent may rely on the parol evidence rule to exclude extrinsic evidence offered by the other. Estate of Craft v. Commissioner, 68 T.C. 249, 260-261 (1977), affd. per curiam 608 F.2d 240 (5th Cir. 1979). The third-party to the instrument rule is an appropriate approach to use since we will be interpreting the Option Agreement to determine if the options granted to petitioner constituted "incentive stock options" within the

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[5] We must deny petitioners' motion for summary judgment because genuine issues of material fact exist with respect to whether the requirements of section 422A(b)(1) were satisfied. Rule 121(b). However, in an effort to assist the parties in narrowing the issues for trial, we will consider whether factual disputes also exist with respect to the requirements of section 422A(b)(2), (4), and (8).

meaning of section 422A(b).[6] Cf. Estate of Craft v. Commissioner, supra at 263.

Duration of Plan

In order to meet the requirement of section 422A(b)(2), an option must be granted within 10 years from the earlier of adoption or approval by stockholders of an incentive stock option plan. Petitioner asserts that that requirement was satisfied, since the option was granted on May 1, 1982, the same day that the Option Agreement was adopted and executed by Epson. Respondent, on the other hand, asserts that the requirement of section 422A(b)(2) was not satisfied since stockholders neither adopted nor approved an incentive stock option plan by entering into the Option Agreement. As we previously concluded, there remains genuine issues of material fact with respect to whether the Option Agreement constituted a properly approved incentive stock option plan. Those issues must be resolved before we can decide whether the requirement of section 422A(b)(2) was satisfied.

Option Price

The option price of an incentive stock option may not be less than the fair market value of the underlying stock at the time the stock option is granted. Sec. 422A(b)(4). However, that requirement is deemed to be satisfied if a good faith effort is made to set the option price at an amount at least equal to the fair market value of the underlying stock at the time the incentive stock option is granted. Sec. 422A(c)(1).

The standard for measuring "fair market value" is the price at which the property would change hands between a hypothetical willing buyer and seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts. United States v. Cartwright, 411 U.S. 546, 551 (1973). Thus, fair market value is inherently a question of fact to be resolved by weighing all the relevant evidence in the record and drawing

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[6] We take a different approach if a case involves a determination under state law as to the existence and extent of legal rights or property interests created by a written instrument. In Estate of Craft v. Commissioner, 68 T.C. 249 (1977), affd. 608 F.2d 240 (5th Cir. 1979), we examined the two approaches taken by this Court in applying the parol evidence rule.

appropriate inferences therefrom. Estate of Gilford v. Commissioner, 88 T.C. 38, 50 (1987). The question of whether an attempt to set the option price at or above the required minimum level was made in good faith and also constitutes an essentially factual question.[7]

Petitioner asserts that he obtained the 6,618 shares of stock in question by paying Computronics an option payment in the amount of $25,000 upon execution of the Option Agreement and $5 per share under the deferred payment plan outlined in said agreement. By adding those two amounts petitioner arrives at a sum of $58,090, or $8.78 per share, which he submits equaled the fair market value of the stock of Computronics as of May 1, 1982, the date the option was granted to him. Petitioner further asserts that he made every effort to pay fair market value for the shares of stock of Computronics. In support of his assertions, petitioner relies primarily upon his affidavit which was filed with this Court. In his affidavit, petitioner characterized Computronics as "a brand new corporation with no track record," and pointed out that at the time of formation Epson contributed on $10 per share for its sole, controlling interest therein. Petitioner also stated in his affidavit that the option price resulted from arm's-length negotiations between the parties to the Option Agreement.

Respondent asserts that the option price was $5 per share. Respondent further asserts that petitioner paid only $33,090, or $5 per share, for the 6,618 shares of stock of Computronics. In that connection, respondent points to the Notice of Exercise of Option dated May 30, 1984, which stated that the purchase price for the 6,618 shares of stock of Computronics was $5 per share, or an aggregate of $33,090, and that the net purchase price (the aggregate purchase price less the amount of available option payment credit) was $28,090. Finally, respondent asserts that the fair market value of the Computronics stock on the date the option was granted exceeded the option price of $5 per share.

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[7] With respect to the stock that is not publicly traded, a good faith attempt is made where the option price for the stock is based upon the average of fair market values determined by "completely independent and well-qualified experts." See sec. 1.422-2(e)(2)(ii), Income Tax Regs.

We conclude on the record before us that genuine issued of material fact remain with respect to (1) the option price,[8] (2) the fair market value of the stock of Computronics on the date the option was granted to petitioner, and (3) the nature of the attempt made in setting the option price.

Annual Dollar Limitation on Grants

Under section 422A(b)(8), the terms of an incentive stock option plan must limit the aggregate fair market value (determined at date of grant) of stock for which any employee may be granted incentive stock options in any calendar year, to not more than $100,000 plus any unused limit carryover.

Petitioner's only assertion regarding any dollar limitation is as follows:[9]

> Since the taxpayer paid a total of $58,000 for the 6,618 shares he received there is no violation of the $100,000 per year limitation and Section 422(a)(d)(1) is met.

Respondent asserts that the fair market value of the stock of Computronics was at least $10 per share at the date of grant of options to petitioner and, therefore, that the Option Agreement failed to foreclose the possibility that the options granted to petitioner were for stock having an aggregate fair market value at the date of grant in excess of the annual dollar limit. As an example, respondent points out that under the Option Agreement petitioner was granted the option to purchase 14,610 shares of stock of Computronics during

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[8] We consider there to be factual dispute regarding the option price because of the discrepancy between the option price set forth in the Option Agreement (i.e., $5 per share) and the amount purportedly paid by petitioner for the 6,618 shares of stock of Computronics (i.e., $8,78 per share).

[9] Petitioner apparently overlooked the applicability of section 422A(b)(8), and asserted instead that the requirement of section 422A(d)(1) (Technical and Miscellaneous Revenue Act of 1988, Pub. L. 100-647, sec. 1003(d)(2)(A), 102 Stat. 3384-3385) was satisfied. However, section 422A(d)(1) applies only with respect to options granted after December 21, 1986. See n. 4, supra.

the calendar year 1986 (i.e., on or after May 1, 1986, but before November 1, 1986), which according to respondent had an aggregate fair market value of at least $146,100.

Because there remains a genuine issue of material fact regarding the fair market value of the stock of Computronics on the date the options were granted to petitioner, we cannot determine whether the terms of the Option Agreement limit the grant of options to petitioner as required by section 422A(b)(8). Moreover, petitioner never specifically made any assertions regarding that requirement.

## Conclusion

In sum, we conclude that genuine issues of material fact exist with respect to whether the requirements needed to establish an incentive stock option under section 422A(b) were satisfied. Consequently, summary adjudication cannot be made under Rule 121(b) because a decision on those issues cannot be rendered as a matter of law. Elkins v. Commissioner, 81 T.C. 669, 681-682 (1983). We do not express any view regarding the holding period and employment requirements of section 422A(a)[10] because denial of

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[10] In order for section 421(a) to apply with respect to the transfer of a share of stock to an individual pursuant to his exercise of an incentive stock option the following requirements of section 422A(a) must be satisfied:

> (1) no disposition of such shares is made by him within 2 years from the date of the granting of the option nor within one year after the transfer of shares to him, and
>
> (2) at all times during the period beginning on the date of the granting of the option and ending on the date 3 months before the date of such exercise, such individual was an employee of either the corporation granting such option, a parent or subsidiary corporation of such corporation, or a corporation or a parent or subsidiary corporation of such corporation issuing or assuming a stock option in a transaction to which section 425(a) applies.

petitioners' motion for summary judgment is otherwise warranted due to the outstanding factual issues regarding the basic requirements of an incentive stock option under section 422A(b).

To reflect the foregoing,

An appropriate order will be issued.

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Sec. 422A(a)(1) and (2).